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ABSTRACT

One of a series of publications directed toward teaching management skills to the small-business man, "The Why and What of Bookkeeping" was prepared to aid in teaching one session of a basic course. It contains materials for a 45- to 60-minute lecture, which is usually followed by a discussion period. Sections of booklet concern: (1) The Lesson Plan--an outline of the material covered, presented in two columns, one of which is the outline and the other is a step-by-step indication of procedure; (2) The Presentation--a subject presentation; (3) The Visual Aids--photographic copies of the set of visual aids that are available; the subject presentation and lesson plan are keyed to the visuals; (4) The Supply Department--materials that may be reproduced locally for distribution to course participants; (5) Cases in Point--short actual small-business management cases; (6) The Incubator--ideas for stimulating further thought and discussion by the participants. A bibliography is provided, and a listing is given of Small Business Administration Field Offices. (DB)

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THE WHY AND WHAT OF BOOKKEEPING

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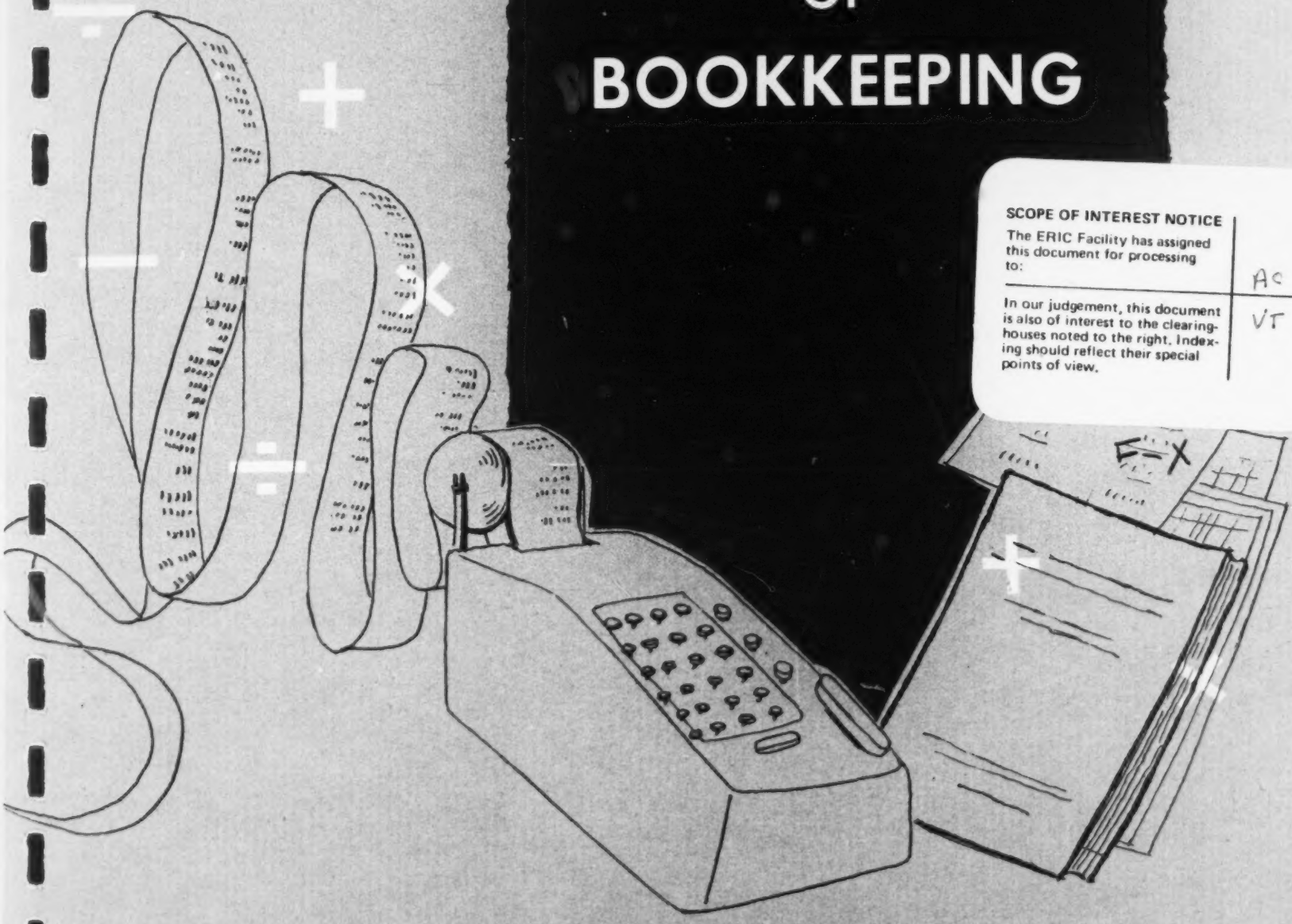

ADMINISTRATIVE MANAGEMENT COURSE PROGRAM

Topic 4

SMALL BUSINESS ADMINISTRATION

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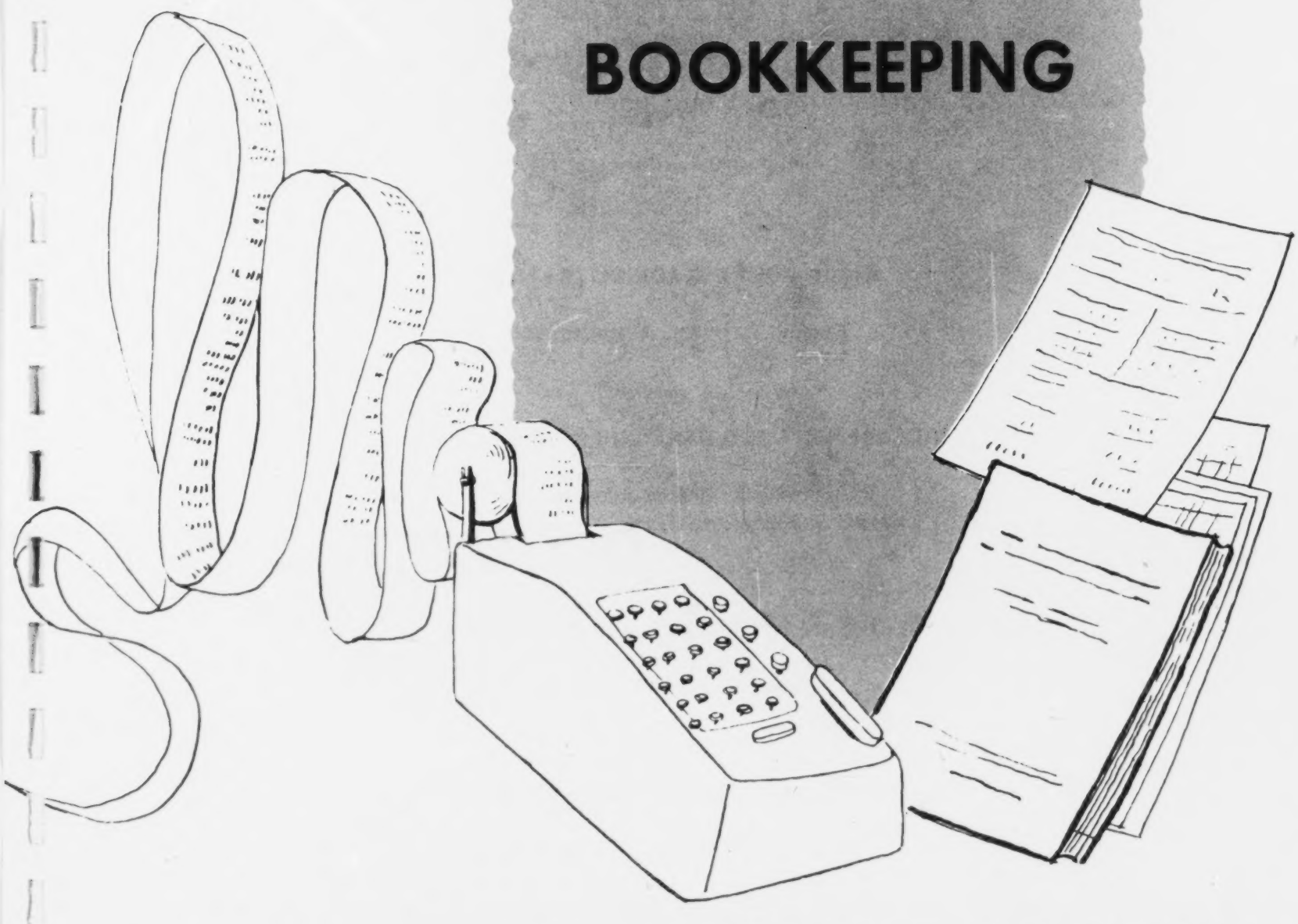
THE WHY AND WHAT OF BOOKKEEPING



ADMINISTRATIVE MANAGEMENT COURSE PROGRAM

Topic 4

Small Business Administration

Washington, D.C. 20416 1965

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FOREWORD

The Administrative Management Course Program was developed by the Small Business Administration in cooperation with educational institutions to bring modern management knowledge and techniques to the owners and managers of small businesses. Within 10 years nearly 900 universities, colleges, and local school systems have cosponsored almost 4,000 courses with this Agency. Over 110,000 owners and managers of small businesses have attended these courses. Distributive Education, working through the local school systems, has accounted for about one-third of these totals.

This is an outstanding demonstration of public spirit and service on the part of these hundreds of educational institutions. Yet, there remain many thousands of small-business owners and managers who have never had the opportunity to attend an administrative management course.

A committee on management education, consisting of representatives of the Small Business Administration and the Distributive Education Division of the American Vocational Association, was formed to study ways of meeting the small-business management needs of the small communities and very small businesses in poverty areas. The committee recommended that a series of subject presentations, including lesson plans, lectures, visual aids, case studies, and handout material, be developed to assist in the establishment of administrative management course programs in new locations. Further, it was felt that this material could substantially assist existing management programs, particularly by emphasizing the importance of continuing education for small-business owners and managers, and by assisting the busy instructor with his preparation.

SBA accepted the responsibility for developing a series of subject presentations in the field of administrative management for use by educators and businessmen who teach these management courses. This booklet is number four in the series of seventeen. We believe that these presentations will be particularly useful to Distributive Education in the smaller community where library research facilities are limited and equipment for the production of visual aids is not readily available. It will also assist community planning groups in implementing the educational provisions of the Economic Opportunity Act of 1964.

The booklet was developed by the Courses and Conferences Division. I wish to express appreciation to the Richmond Public Schools System for granting leave of absence to John O. Perreault, who drafted the booklet. The final version was prepared by John W. Clark and Robert A. Litzberg under the administrative direction of George C. Willman, Jr., Acting Chief of the Division. Thomas O. Barnes was editorial assistant. Artwork and visuals were prepared by the Graphics and Design Branch, Office of Administrative Services.

Eugene P. Foley
Administrator

September 1965

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*A set of the visual aids is available from the nearest SBA regional office. These visuals are 8- by 10-inch colored transparencies for use on overhead projectors.

**Among the materials prepared as "handouts" to participants are several SBA free publications. Current information on the availability of suggested and new SBA publications may be obtained from the nearest SBA office.

A WORD ABOUT THIS SESSION

This publication, one of a series, is directed toward teaching management skills to the small-business man. When the term "management" is used, it refers to administrative management functions rather than to purely operational features of business. The complete set of subject presentations may be obtained on loan from the nearest Small Business Administration field office (listed on the inside back cover). Single booklets or complete sets may be purchased from the Superintendent of Documents, Washington, D.C. 20402.

This topic, The Why and What of Bookkeeping, was prepared to aid in teaching one session of a basic course. It contains sufficient material for a 45- to 60-minute lecture which is usually followed by a discussion period. The management case on page 51 can be used to extend the session or to form the basis for a second session on the topic.

The lecture is designed to be presented to the layman in layman's language. Therefore, it is not written as a Certified Public Accountant might present the subject. Instructors who are accountants or who otherwise have a depth of knowledge in this field may wish to revise the presentation considerably. Also, instructors who will be teaching more sophisticated participants may wish to revise the presentation to reflect the training or special needs of their students.

This topic may be handled by a banker, a financial executive, or another whose training, experience, and interest qualify him. Guide for Part-Time Instructors, Distributive Education for Adults, a publication of the U. S. Office of Education, may prove useful to local instructors.

The various sections of the publication are separated by divider sheets of different colors. On the following page, these colors are given and the contents of the sections are briefly described.

Gray -- The Lesson Plan. An outline of the material covered which may be used as a teaching guide, or as a framework for developing an individualized presentation. The lesson plan contains two columns: the left-hand column is an outline of the presentation; the right is a step-by-step indication of procedure, including chalk-board suggestions, quotations, discussion points, and a keyed guide to the visual aids supplied.

Rust -- The Presentation. A carefully prepared subject presentation which may be used as written or modified to meet local needs and conditions. It may also be used as a source of information by a person preparing his own lecture.

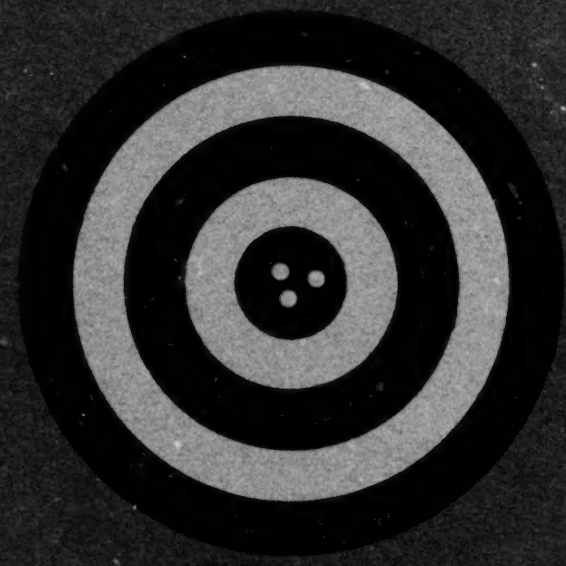
Buff -- The Visual Aids. Photographic copies of the set of visual aids which are available for this topic. These visuals are 8- by 10-inch colored transparencies prepared for use on overhead projectors. The subject presentation and lesson plan are keyed to the visuals. A set of visuals for each subject in this series may be borrowed from the nearest SBA regional office.

Green -- The Supply Department. Materials which may be reproduced locally for distribution to course participants. Your nearest SBA office can furnish information on current availability of SBA free publications, including titles published subsequent to this volume.

Yellow -- Cases in Point. Short actual small-business management cases which may be used to augment the presentation and to develop discussion, or as the basis for a second session on the same topic.

Blue -- The Incubator. Ideas for stimulating further thought and discussion by the participants. This material may be reproduced locally for distribution to course participants. "Assignments" are designed to aid in retention of the subject matter of the session.

Note: See back cover for index reference to the divider sheets.



THE LESSON PLAN

A Keeping on Target

Section

Good teaching depends on good planning. A session objective or target must be set. Then the points are selected that will enable one to keep hitting on the heart of that target.

The primary aim of the instructor is to first give the participant the things he MUST KNOW, then the things he SHOULD KNOW. When these two aims have been achieved, the topic can be embellished with the like or lesser but helpful or funny elements.

The following lesson plan is "on target." If it is used as a guide, it will provide the structure to emphasize the major points. Use of the suggestions will stimulate the participants to grasp the subject.

STIMULATE GROUP BY SERVING AN INSTRUCTIONAL COCKTAIL

RECIPE

Use The Three B's (Bubbles)

- ***Base*** instruction on problems at learners level.
- ***Blend*** instruction with job experience.
- ***Brighten*** instructions with variety of ***illustrations, investigations*** and group ***participation.***

FOUR BASIC STEPS OF INSTRUCTION

Instructing is like selling - -

Selling

1. Approach customer
   - Promptness
   - Put at ease
   - Awaken ***interest***
2. Present merchandise or service
   - Select merchandise to fit need
   - Show one item at a time
   - Demonstrate ***selling points***
3. Have customer take part
   - Get merchandise into customer's hands
   - Let customer "try on" merchandise
   - Answer questions and meet objections
4. Bring sale to close
   - Help customers decide; ask:
     - "which"
     - "for whom"
     - "when"
   - Be sure merchandise fits need
   - Summarize points of care and use
   - Handle mechanics of sale
   - Pave way for return visit

Instructing

1. Prepare the group
   - Start on schedule
   - Put group at ease
   - ***Awaken*** interest
2. Present information
   - Gauge material to needs
   - Present one point at a time
   - ***Show, illustrate, question***
3. Have group participate
   - Get group to ***discuss***
   - Have members ***demonstrate*** or ***use*** ideas
   - Answer questions and correct errors
4. Bring meeting to a close
   - Check on understanding; ask:
     - "why" "how"
     - "when" "what"
     - "where" "who"
   - Be sure group now can use information
   - Summarize "take away" ideas
   - Make a definite conclusion
   - Pave way for next session

1

How To Deal With "Difficult Customers"

	What To Do
THE "MOUTH"—wants to do all the talking.	Take the play away from him by asking others to comment on his remarks. Deliberately turn to others and ask for their opinions. Avoid looking at him. Tactfully ask him to give someone else a chance, or talk to him in private.

THE "ARGUER"—constantly tries to catch you up.	Keep cool. You can never "win" an argument. Always make him back it up. Ask for evidence. Avoid getting personal. Refer the question to the group and then to him.

THE "MOUSE"—is in every group.	Call him by name and ask him for an opinion. Ask him an easy question he is sure to answer well, then praise him. This person is worthy of your attention.

THE "SO-WHATER"—is disinterested.	Point up something he has done as a good example of the point being stressed. Ask direct questions affecting his work.

LESSON PLAN

TOPIC: THE WHY AND WHAT OF BOOKKEEPING

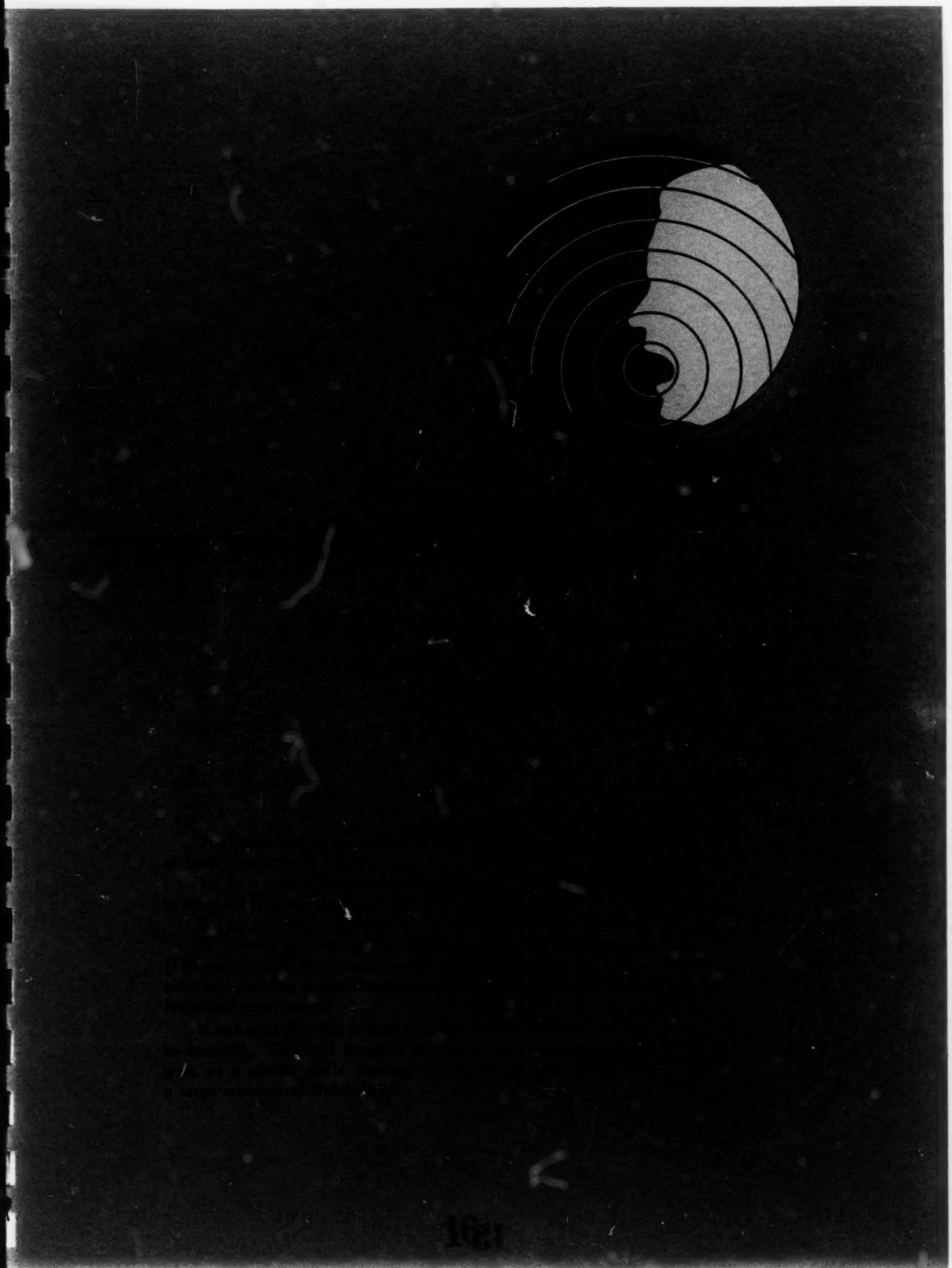
OBJECTIVES: To emphasize the importance of bookkeeping records to the manager.
To examine the make-up and relative importance of the basic bookkeeping records.

SESSION CONTENT	TIPS AND APPROACHES
I. INTRODUCTION	
A. Management misconceptions	Emphasize incorrect attitudes of small-business man.
B. Requirements of good records system	List on blackboard: simplicity, understandability, reliability, accuracy, consistency, readiness.
II. IMPORTANT BOOKKEEPING RECORDS	Visual No. 4-1.
A. Journal	
B. Ledgers	Briefly describe these bookkeeping records.
C. Balance sheet	
D. Income statement	
E. Funds flow statement	
III. THE BALANCE SHEET	
A. Definition	
B. Dual-aspect concept	
C. Balance sheet formula	Visual No. 4-2. Assets = Liabilities + Equity

D. Balance sheet format	Visual No. 4-3.
1. Assets	Visual No. 4-4.
a. Current assets	Describe each asset item.
(1) Cash	
(2) Accounts receivable	
(3) Inventory	
(4) Prepaid expenses	
b. Fixed assets	
(1) Land	
(2) Buildings	
(3) Equipment	
(4) Depreciation	
c. Other assets	
2. Liabilities	Visual No. 4-5.
a. Current liabilities	Describe each liabilities item.
(1) Accounts payable	
(2) Short-term loans	
(3) Accrued expenses	
b. Long-term liabilities	
(1) Long-term loans	
(2) Mortgages	
(3) Bonds	
3. Owner's equity	Define owner's equity.
a. Owner's investment	
b. Earned surplus	
c. Operating deficit	
E. Summary	Visual No. 4-6; Handout No. 4-1.
IV. INCOME STATEMENT	
A. Definition	
B. Income statement items	Visuals No. 4-7; Handout No. 4-2.
1. Sales	
2. Cost of goods sold	Visual No. 4-8.
3. Gross margin	

4. Expenses	Visual No. 4-9. Discuss expenses incurred by Blank Company.
a. Salaries and wages b. Utilities c. Depreciation d. Interest e. Administrative expenses f. Supplies g. Bad debt h. Advertising i. Taxes j. Rent k. Traveling expense l. Commissions m. Shrinkage	Mention other expenses often incurred by small firms.
5. Net profit a. Before taxes b. Profit tax c. Net profit after taxes	
V. FUNDS FLOW STATEMENT	
A. Definition	
B. Funds vs. cash	Discuss.
C. Format of funds flow	Visual No. 4-10.
1. Use of funds a. Increase in assets b. Decrease in liabilities	
2. Source of funds a. Decrease in assets b. Increase in liabilities c. Increase in owner's equity	

3. Use of funds flow	Visual No. 4-11. Blank Company example. Show how funds flow analysis can help answer question "Should I buy new capital equipment?" See example, page 21, this manual.
VI. OTHER RECORDS	Visual No. 4-12.
A. Daily summary of sales and cash receipts	Use Handout No. 4-3. Illustrate various entries.
1. Definition	
2. Description of components	
3. The petty-cash fund	Visual No. 4-13.
4. The change fund	
B. Record of cash disbursement	
1. The checkbook	
2. Bank statement reconciliation	
C. Accounts receivable records	
1. Individual customer records	
2. Aging customer records	Visual No. 4-14.
D. Property records and depreciation	
1. Definition	
2. Need for records	
E. Schedule of insurance records	
VII. CONCLUSION	Hand out Focal Points No. 4.



THE WHY AND WHAT OF BOOKKEEPING

INTRODUCTION

Why keep records? If you are a typical small-business man, your answer to this question is probably, "Because the Government requires it!" And if the question comes in the middle of a busy day, you may add a few heartfelt words about the amount of time you have to spend on records--just for the Government.

Is it "just for the Government," though? True, regulations of various governmental agencies have greatly increased the record-keeping requirements of business. But this may be a good thing for the small-business man, overburdened though he is.

Many small-business managers don't recognize their book-keeping records for what they can really do. Their attitudes concerning these records are typified by one businessman who said, "Records only tell you what you have done in the past. It's too late to do anything about the past; I need to know what is going to happen in the future." However, the past can tell us much about what may happen in the future; and, certainly we can profit in the future from knowledge of our past mistakes.

These same managers may recognize that records are necessary in filing their tax returns, or that a banker requires financial information before he will lend money, but often their appreciation of their bookkeeping systems ends at this point. However, there are many ways in which the use of such information can help an owner manage his business more easily and profitably.

The small-business man is confronted with an endless array of problems and decisions every day. Sound decisions require an informed manager; and many management problems can be solved with the aid of the right bookkeeping information.

Requirements of a Good Record System

Of course, to get information that is really valuable to you--to get the right information--requires a good bookkeeping system. What are the characteristics of a good system? You want one that is simple and easy to understand, reliable, accurate, consistent, and one that will get the information to you promptly.

A simple, well-organized system of records, regularly kept up, can actually be a timesaver--by bringing order out of disorder. Furthermore, competition is very strong in today's business areas. A businessman needs to know almost on a day-to-day basis where his business stands profitwise, which lines of merchandise or services are the most or the least profitable, what his working-capital needs are, and many other details. He can get this information with reasonable certainty only if he has a good recordkeeping system--one that gives him all the information he needs.

In setting up a recordkeeping system that is tailored to your business, you will probably need the professional help of a competent accountant. And you may want to retain the services of an accountant or bookkeeper to maintain these records. But it is your job to learn to interpret this information and to use it effectively.

One of the reasons that many managers have misgivings about keeping records is that they don't understand them or know how they can be used. The owner or manager of a small business may be an expert in his line of business; however, he generally does not have a background in keeping records. So he is usually confused. What we will try to do in this discussion is to highlight the "why and what of bookkeeping." In so-doing, we aim to eliminate that confusion.

IMPORTANT BOOKKEEPING RECORDS

Today's managers should be familiar with the following bookkeeping records:

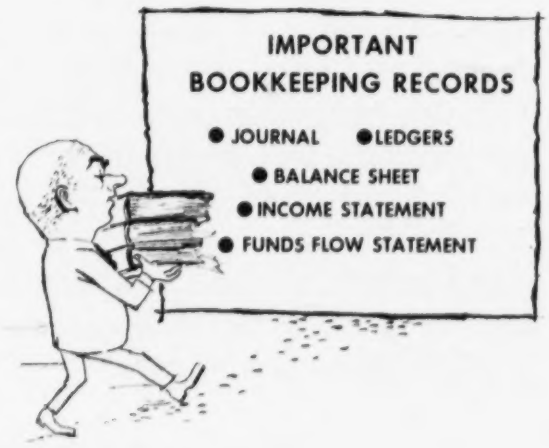
Journal

Ledgers

Balance sheet

Income statement

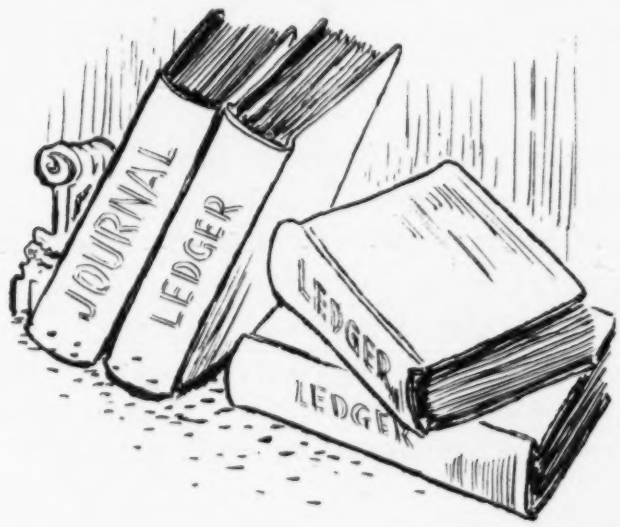
Funds flow statement



Visual No. 4–1

We will discuss each of them in turn. In addition, a brief discussion of other supporting records will be made.

Bookkeeping Books



The journal, which accountants call "the book of original entry," is a chronological record of all business transactions engaged in by the firm. It is simply a financial diary. The ledgers, or "books of account," are more specialized records used to classify the journal entries according to like elements. For example, there would be a separate ledger account for cash entries, another for all sales, and still others for items such as accounts receivable, inventory, and loans. All transactions are first entered in the journal, and then posted in the appropriate ledger. The journal and ledgers are of minor importance to the manager in making decisions, but they play a vital role for the accountant or bookkeeper because the more important accounting statements such as the balance sheet and the income statement are derived from the journal and ledger entries.

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Financial Reports

The two principal financial reports in most businesses are the balance sheet and the income statement. Up to about 25 or 30 years ago, the balance sheet was generally considered to be the most important financial statement. Until that time, it was generally used only as a basis for the extension of credit and bank loans, and very little thought was given to the information it offered that might be important in the operation and management of the business. Starting about 30 years ago, emphasis has gradually shifted to the income statement. Today the balance sheet and income statements are of equal importance, both to the accountant in financial reporting and to the manager faced with a multitude of administrative problems.

Essentially, the balance sheet shows what a business has, what it owes, and the investment of the owners in the business. It can be likened to a snapshot, showing the financial condition of the business at a certain point in time. The income statement, on the other hand, is a summary of business operations for a certain period--usually between two balance sheet dates. The income statement can be compared to a moving picture; it indicates the activity of a business over a certain period of time. In very general terms, the balance sheet tells you where you are, and the income statement tells you how you got there since the last time you had a balance sheet prepared.

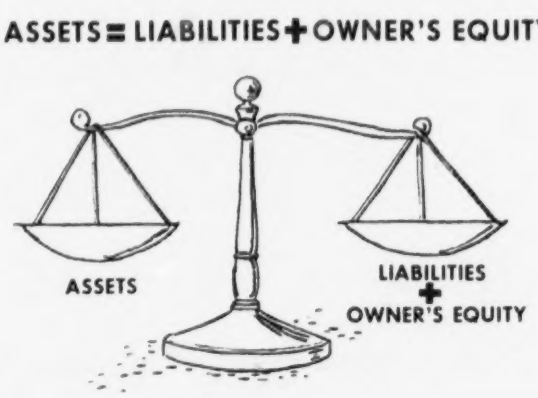
Both the balance sheet and income statement can be long and complicated documents. Both accountants and management need some device that can highlight the critical financial information contained in these complex documents. Certain standard ratios or relationships between items on the financial statements have been developed that allow the interested parties to quickly determine important characteristics of the firm's activities. There are many relationships that might be important in a specific business that would not be as significant in another.

Other devices of the bookkeeper, such as funds flow statements, daily summaries of sales and cash receipts, the checkbook, account receivable records, property depreciation records, and insurance scheduling have also been found useful to management.

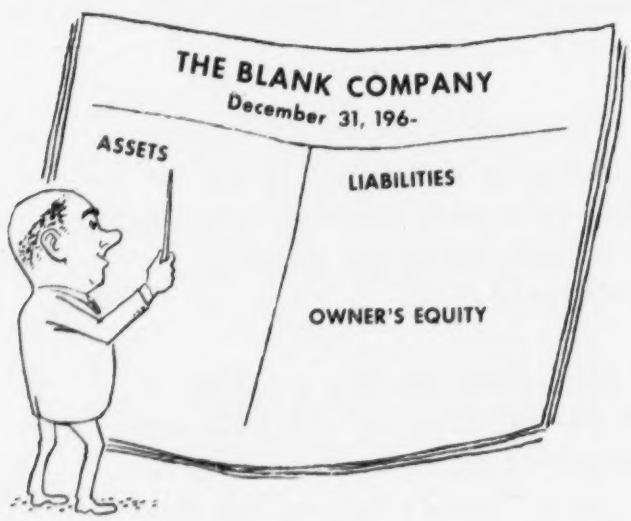
THE BALANCE SHEET

As stated earlier, the balance sheet represents what a business has, what it owes, and the investment of the owners. The things of value that the business has or owns are called assets. The claims of creditors against these assets are called liabilities. The value of the assets over and above the liabilities can be justifiably called the owner's claim. This amount is usually called the owner's equity (or net worth).

This brings us to the dual-aspect concept of bookkeeping. The balance sheet is set up to portray two aspects of each entry or event recorded on it. For each thing of value, or asset, there is a claim against that asset. The recognition of this concept leads to the balance sheet formula: ASSETS = LIABILITIES + OWNER'S EQUITY. Let's take an example to clarify this concept. Suppose Joe Smith decides to start a business. He has $2,000 cash in the bank. He got this sum by investing $1,000 of his own money and by borrowing $1,000 from the bank. If he were to draw up a balance sheet at this time, he would have assets of $2,000 cash balanced against a liability claim of $1,000 and an owner's claim of $1,000. Using the balance sheet formula: $2,000 = $1,000 + $1,000. This formula means there will always be a balance between assets and claims against them. The balance sheet always balances unless there has been a clerical error.



Visual No. 4–2



Visual No. 4–3

The balance sheet is usually constructed in a two-column format. The assets appear in the left hand column and the claims against the assets (the liabilities and owner's equity) are in the right hand column. Other formats are sometimes used; but, in any case, the balance sheet is an itemized or detailed account of the basic formula: assets = liabilities + owner's equity.

Assets

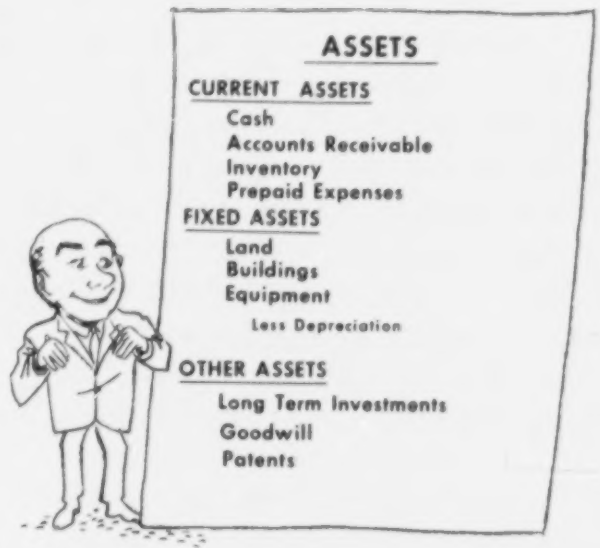
I have been speaking of assets belonging to the business. Of course, the business does not legally own anything unless it is organized as a corporation. But regardless of whether the business is organized as a proprietorship, a partnership, or a corporation, all business bookkeeping should be reckoned and accounted apart from the accounting of the personal funds and assets of its owners.

Assets are typically classified into three categories:

Current assets

Fixed assets

Other assets



Visual No. 4–4

Current Assets

For bookkeeping purposes, the term "current assets" is used to designate cash and other assets which can be converted to cash during the normal operating cycle of the business (usually one year). The distinction between current assets and noncurrent assets is important since lenders and others pay much attention to the total amount of current assets. The size of current assets has a significant relationship to the stability of the business because it represents, to some degree, the amount of cash that might be raised quickly to meet current obligations. Here are some of the major current asset items.

Cash consists of funds that are immediately available to use without restrictions. These funds are usually in the form of checking-account deposits in banks, cash-register money, and petty cash. Cash should be large enough to meet obligations that are immediately due.

Accounts receivable are amounts owed to the company by its customers as a result of sales. Essentially, these accounts are the result of granting credit to customers. They may take the form of charge accounts where no interest or service charge is made, or they may be of an

interest-bearing nature. In either case they are a drain on working capital. The more that is outstanding on accounts receivable, the less money that is available to meet current needs. The trick with accounts receivable is to keep them small enough so as not to endanger working capital, but large enough to keep from losing sales to credit-minded customers.

Inventory is defined as those items which are held for sale in the ordinary course of business, or which are to be consumed in the production of goods and services that are to be sold. Since accountants are conservative by nature, they include in inventory only items that are salable, and these items are valued at cost or market value, whichever is lower. Control of inventory and inventory expenses is one of management's most important jobs--particularly for retailers--and good bookkeeping records in this area are particularly useful.

Prepaid expenses represent assets, paid for in advance, but whose usefulness will usually expire in a short time. A good example of this is prepaid insurance. A business pays for insurance protection in advance--usually three to five years in advance. The right to this protection is a thing of value--an asset--and the unused portion can be refunded or converted to cash.

Fixed Assets

"Fixed assets" are items owned by the business that have relatively long life. These assets are used in the production or sale of other goods and services. If they were held for resale, they would be classified as inventory, even though they might be long-lived assets.

Normally these assets are composed of land, buildings, and equipment. Some companies lump their fixed assets into one

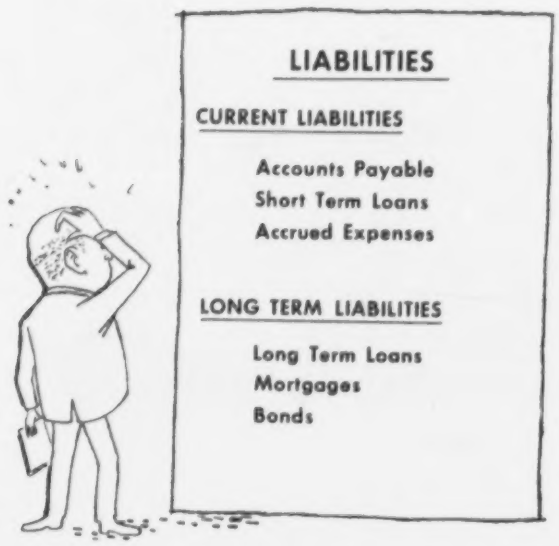
entry on their balance sheets, but you gain more information and can exercise more control over these assets if they are listed separately on the balance sheet. You may even want to list various types of equipment separately.

There is one other aspect of fixed-asset bookkeeping that we should discuss--and this is depreciation. Generally fixed assets--with the exception of land--depreciate, or decrease in value with the passing of time. That is, a building or piece of equipment that is five years old is not worth as much as it was when it was new. For a balance sheet to show the true value of these assets, it must reflect this loss in value. For both tax and other accounting purposes, the businessman is allowed to deduct this loss in value each year over the useful life of the assets, until, over a period of time, he has deducted the total cost of the asset. There are several accepted ways to calculate how much of an asset's value can be deducted for depreciation in a given year. This information and other facts concerning depreciation are discussed in Small Marketers Aid No. 68, Depreciation Costs - Don't Overlook Them, which is available free from the SBA. (See Supply Department.) Depreciation is allowed as an expense item on the income statement, and we will discuss this fact later.

Other Assets

"Other assets" is a miscellaneous category. It accounts for any investments of the firm in securities, such as stock in other private companies or government bonds. It also includes intangible assets such as goodwill, patents, and franchise costs. Items in the "other-assets" category have a longer life than current-asset items.

Liabilities



Visual No. 4–5

"Liabilities" are the amounts of money owed by the business to people other than the owners. They are claims against the company's total assets, although they are not claims against any specific asset, except in the cases of some mortgages and equipment liens. Essentially, liabilities are divided into two classes:

Current liabilities

Long-term liabilities.

Current Liabilities

The term "current liabilities" is used to describe those claims of outsiders on the business that will fall due within one year. Here are some of the more important current-liabilities entries on the balance sheet:

Accounts payable represent the amounts owed to vendors, wholesalers, and other suppliers from whom the business has bought items on account. This includes any items of inventory, supply, or capital equipment which have been purchased on credit and for which payment is expected in less than one year. For example, a retail butcher purchased 500 pounds of meat for $250, a quantity of fish that cost $50, and a new air-conditioning unit for his store for $450. He bought all of these items on 60-day terms. His accounts payable were increased by $750. Of course, at the same time his inventory increased by $300 and his fixed assets rose by $450. If he had paid cash for these items, his accounts payable would not have been affected, but his cash account would have decreased by $750, thus keeping the accounting equation in balance.

Short-term loans, which are sometimes called notes payable, are loans from individuals, banks, or other lending institutions which fall due within a year. Also included in this category is the portion of any long-term debt that will come due within a year.

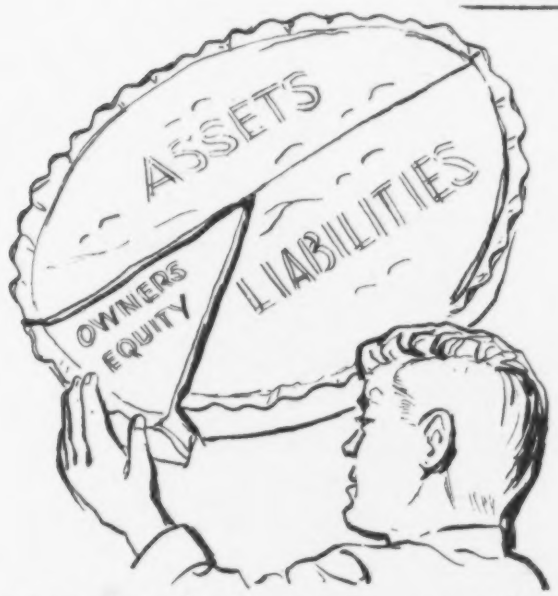
Accrued expenses are obligations which the company has incurred, but for which there has been no formal bill or invoice as yet. An example of this is accrued taxes. The owner knows the business has the obligation to pay taxes; and they are accruing or accumulating each day. The fact that the taxes do not have to be paid until a later date

does not diminish the obligation. Another example of accrued expenses is wages. Although wages are paid weekly or monthly, they are being earned hourly or daily and constitute a valid claim against the company. An accurate balance sheet will reflect these obligations.

Long-Term Liabilities

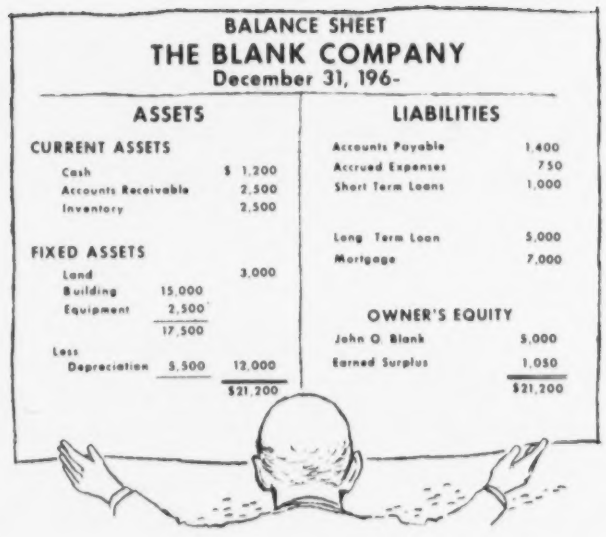
Claims of outsiders on the business that do not come due within one year are called "long-term liabilities" or, simply, "other liabilities." Included in this category are bonded indebtedness, mortgages, and long-term loans from individuals, banks, and others from whom the business may borrow money, such as the SBA. As was stated before, any part of a long-term debt that falls due within one year from the date of the balance sheet would be recorded as part of the current liabilities of the business.

Owner's Equity



The owner's equity section of the balance sheet is located on the right-hand side underneath the listing of the liabilities. It shows the claims of the owners on the company. Essentially, this is a balancing figure--that is, the owners get what's left of the assets after the liability claims have been recognized. This is an obvious definition, if you will remember the balance sheet formula. Transposing the formula as we learned it a few minutes ago, it becomes Assets - Liabilities = Owner's Equity. In the case where the business is a sole proprietorship, it is customary to show owner's equity as one entry with no distinction being made between the owner's initial investment and the accumulated retained earnings of the business. However, in the case of an incorporated business, there are entries for stockholders' claims as well as for earnings that have been accumulated and retained in the business. Of course, if the business has been consistently operating at a loss, the proprietor's claim may be less than his initial investment. And, in the case of a corporation, the balancing account could be operating deficit rather than retained earnings.

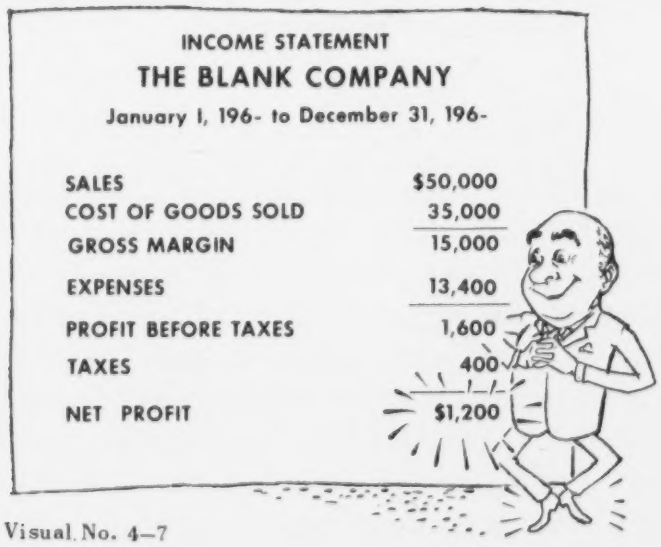
If we put together the entries we have been talking about, we have a complete balance sheet (such as the one shown in Visual No. 6 for the Blank Company). There is a lot of information in this statement. It tells you just what you have and where it is. It also tells you what you owe. You need this information to help you decide what actions you should take in running your business. If you need to borrow money, the banker or anyone else from whom you borrow will want to look at your balance sheet.



Visual No. 4–6

THE INCOME STATEMENT

In recent years the income statement has become as important as the balance sheet as a financial and management record. It is also called the profit and loss statement, or simply the P and L statement. This financial record summarizes the activities of the company over a period of time, listing those that can be expressed in dollars. That is, it reports the revenues of the company and the expenses incurred in obtaining the revenues, and it shows the profit or loss resulting from these activities. The income statement complements the balance sheet. While balance sheet analysis shows the change in position of the company at the end of accounting periods, the income statement shows how the change took place during the accounting period. Both reports are necessary for a full understanding of the operation of the business.



Visual No. 4–7

The income statement for a particular company should be tailored to fit the activities of that company, and there is no rigid format that must be followed in constructing this report. But the following categories are found in most income statements.

Sales

The major activity of most businesses is the sales of products and services, and the bulk of revenue comes from sales. In recording sales, the figure used is net sales--that is, sales after discounts, allowances, and returned goods have been accounted for.

Cost of Goods Sold

Another important item, in calculating profit or loss, is the cost of the goods that the company has sold. This item is difficult to calculate accurately. Since the goods sold come from inventory, and since the company may have bought parts of its inventory at several prices, it is hard to determine exactly what is the cost of the particular part of the inventory that was sold. In large companies, and particularly in companies using cost accounting, there are some rather complicated methods of determining "cost of goods sold," but they are beyond the scope of this presentation. However, there is a simple, generally accepted way of calculating cost of goods sold. In this method you simply add the net amount of purchases during the accounting period to your beginning inventory, and subtract from this your ending inventory. The result can be considered cost-of-goods sold.

COST OF GOODS SOLD

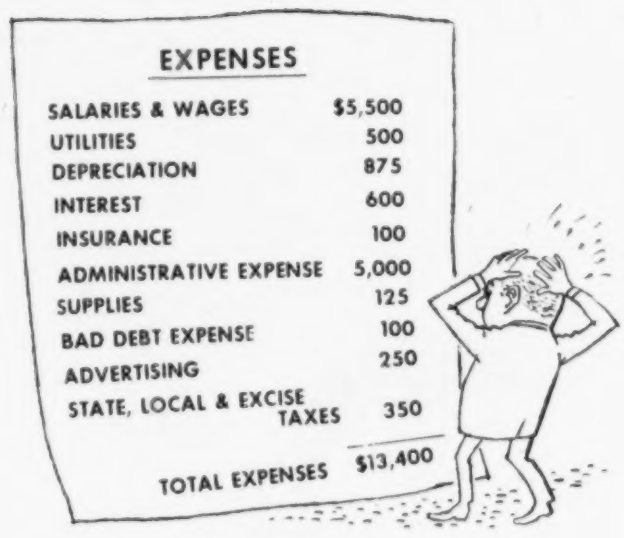
BEGINNING INVENTORY	$ 2,400
PURCHASES	+ 35,100
GOODS AVAILABLE FOR SALE	= 37,500
ENDING INVENTORY	− 2,500
COST OF GOODS SOLD	= $35,000

Visual No. 4--8

Gross Margin

The difference between sales and cost of goods sold is called the "gross margin" or gross profit. This item is often expressed as a percentage of sales, as well as in dollar figures. The percentage gross margin is a very significant figure because it indicates what the average markup is on the merchandise sold. So, if a manager knows his expenses as a percentage of sales, he can calculate the markup necessary to obtain the gross margin he needs for a profitable operation. It is surprising how many small-business men do not know what basis to use in setting markups. In fact, with the various allowances, discounts, and markdowns that a business may offer, many managers do not know what their markup actually is. The gross margin calculation on the income statement can help the manager with this problem.

There are other costs of running a business besides the cost of the goods sold. When you use the simple method of determining costs of goods sold, these costs are called "expenses."



Visual No. 4-9

For example, here are some typical expenses: salaries and wages, utilities, depreciation, interest, administrative expenses, supplies, bad debts, advertising, and taxes--Federal, State, and local. These are typical expenses, but there are many other kinds of expenses that may be experienced by other businesses. For example, we have shown in the Blank Company's balance sheet that he owns his own land and building--with a mortgage, of course. This accounts for part of his depreciation and interest expenses, but for a company that rents its quarters, rent would appear as the expense item. Other common expenses are traveling expense, commissions, and advertising.

Most of these expense items are self-explanatory, but there are a few that merit further comment. For one thing, the salary or draw of the owner should be recorded among the expenses--either as a part of salaries and wages or as part of administrative expenses. To exclude the owner's compensation from expenses distorts the actual profitability of the business. And, if the company is incorporated, it would reduce the allowable tax deductions of the business. Of course, for tax purposes, the owner's salary or draw in a proprietorship or partnership is considered as part of the net profit.

We discussed depreciation when we examined the balance sheet, and we mentioned that it was an item of expense. Although no money is actually paid out for depreciation, it is a real expense because it represents reduction in the value of the assets.

The most important thing about expenses is to be sure to include all of the expenses that the business incurs. This not only helps the owner get a more accurate picture of his operation but it allows him to take full advantage of the tax deductions that legitimate expenses offer.

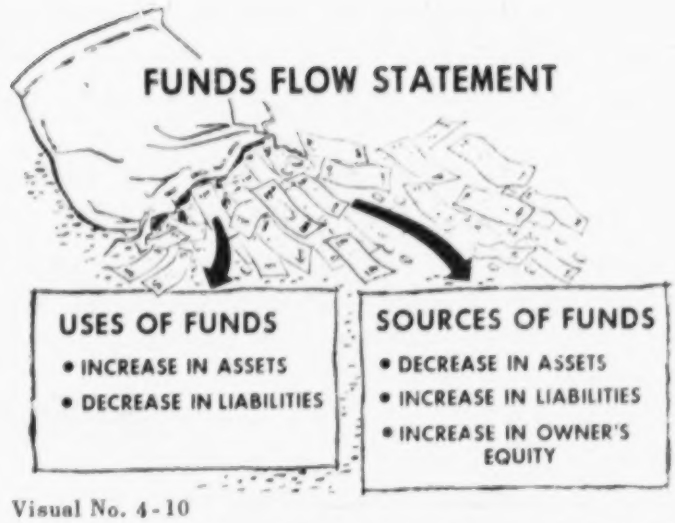
Net Profit

In a typical company, when expenses are subtracted from gross margin, the remainder is profit. However, if the business receives revenue from sources other than sales, such as rents, dividends on securities held by the company, or interest on money loaned by the company, it is added to profit at this point. For bookkeeping purposes, the resulting profit is labeled "profit before taxes." This is the figure from which Federal income taxes are figured. If the business is a proprietorship, the profit is taxed as part of the owner's income. If the business is a corporation, the profits may be taxed on the basis of the corporate income tax schedule. When income taxes have been accounted for, the resultant entry is called "net profit after taxes," or simply "net profit." This is usually the final entry on the income statement.

Another financial record which managers can use to advantage is the funds flow statement. This statement is also called statement of sources and uses of funds and sometimes the "where got--where gone" statement. Whatever you call it, a record of sources and uses of past funds is useful to the manager. He can use it to evaluate past performance, and as a guide in determining future uses and sources of money.

When we speak of "funds" we do not necessarily mean actual "dollars" or "cash." Although accounting records are all written in monetary terms, they do not always involve an exchange of money. Many times in business transactions, it is credit rather than dollars that changes hands. Therefore, when we speak of funds flow, we are speaking of exchanges of economic values rather than merely the physical flow of dollars.

Basically, funds are used to: increase assets and reduce liabilities. They are also sometimes used to reduce owner's equity. An example of this would be the use of company funds to buy up outstanding stock or to buy out a partner. Where do funds come from? The three basic sources of funds are a reduction in assets, increases in liabilities, and increased owner's equity. All balance sheet items can be affected by the obtaining and spending of company funds.



Visual No. 4-10

COMPARISON OF SELECTED BALANCE SHEET ITEMS
THE BLANK COMPANY

	LAST YEAR	THIS YEAR	SOURCE OF FUNDS	USE OF FUNDS
ASSETS				
CASH	1500	1200	300	
ACCOUNTS RECEIVABLE	2200	2500		300
INVENTORY	2300	2500		200
EQUIPMENT	2000	2500		500
LIABILITIES				
ACCOUNTS PAYABLE	1000	1400	400	
LONG TERM LOANS	5000	5000		
MORTGAGE	8000	7000		1000
OWNER'S EQUITY				
JOHN Q. BLANK	4500	5000	500	
EARNED SURPLUS	250	1050	800	

Visual No. 4-11

To examine the construction and use of a funds flow statement, let's take another look at the Blank Company. Here we show comparative balance sheets for two one-year periods (Visual No. 12). For the sake of simplicity, we have included only selected items from the balance sheets for analysis. Notice that the company gained funds by:

reducing cash $300,

increasing accounts payable $400,

putting $500 more owner's equity in the business, and

plowing back $800 of the profit into the business.

These funds were used to:

increase accounts receivable $300,

increase inventory $200,

buy $500 worth of equipment, and

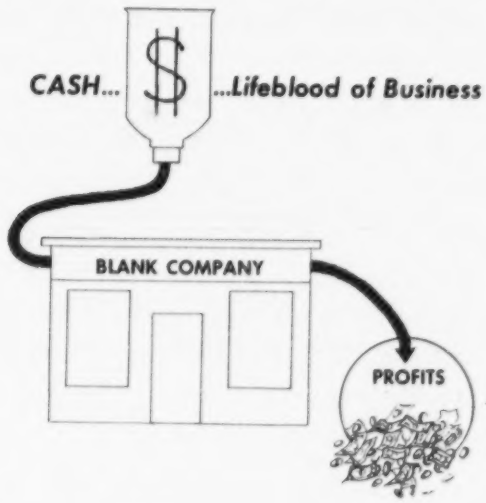
pay off $1,000 worth of long-term debt.

This funds flow statement has indicated to Mr. Blank where he has gotten his funds and how he has spent them. He can analyze these figures in the light of his plans and objectives and take appropriate action.

For example, if Mr. Blank wants to answer the question "Should I buy new capital equipment?" a look at his funds flow statement would show him his previous sources of funds, and it would give him a clue as to whether he could obtain funds for any new equipment.

OTHER RECORDS

Up to this point, we have been talking about the basic types of bookkeeping records. In addition, we have discussed the two basic financial statements of a business: the balance sheet and the profit and loss statement. Now let us give our attention briefly to some other records which are very helpful to running a business successfully.



Visual No. 4-12

One element that appears on the balance sheet which I believe we can agree is important is cash. Because it is the lifeblood of all business, cash should be controlled and safeguarded at all times. The daily summary of sales and cash receipts and the checkbook are used by many managers of small businesses to help provide that control.

Daily Summary of Sales and Cash Receipts

Not all businesses summarize their daily transactions. However, a daily summary of sales and cash receipts is a very useful tool for checking how your business is doing on a day-to-day basis. At the close of each day's business, the actual cash on hand is counted and "balanced" against the total of the receipts recorded for the day. This balancing is done by means of the Daily Summary of Sales and Cash Receipts. (Handout No. 4-3). This is a recording of every cash receipt and every charge sale, whether you use a cash register or sales checks or both. If you have more than one cash register, a daily summary should be prepared for each; the individual cash-register summaries can then be combined into one overall summary for convenience in handling.

In the daily summary form used for purposes of illustration, (see Handout), the first section, "Cash Receipts," records the total of all cash taken in during the day from whatever source. This is the cash that must be accounted for over and above the amount in the change and/or petty cash funds. We shall touch upon these two funds later. The three components of cash receipts are (1) cash sales, (2) collections on accounts, and (3) miscellaneous receipts.

The daily total of cash sales is obtained from a cash-register tape reading or, if no cash register is used, by totaling the cash-sales checks.

For collections on accounts, an individual record of each customer payment on account should be kept, whether or not these collections are rung up on a cash register. The amount to be entered on the daily summary is obtained by totaling these individual records.

Miscellaneous receipts are daily cash transactions that cannot be classified as sales or collections. They might include refunds from suppliers for overpayment, advertising rebates or allowances, collections of rent from sub-leases or concessions, etc. Like collections on account, a sales check or memo should be made out each time such cash is taken in.

The total of daily cash receipts to be accounted for on the daily summary is obtained by adding cash sales, collections on account, and miscellaneous receipts.

The second section, "Cash on Hand," of a daily summary is a count of the cash actually on hand plus the cash that is represented by petty cash slips. The daily summary provides for counts of your total coins, bills, and checks as well as the amount expended for petty cash. The latter is determined by adding the amounts on the individual petty cash slips. By totaling all four of these counts, you obtain the total cash accounted for. To determine the amount of your daily cash deposit, you deduct from the "total cash accounted for" the total of the petty cash and change funds.

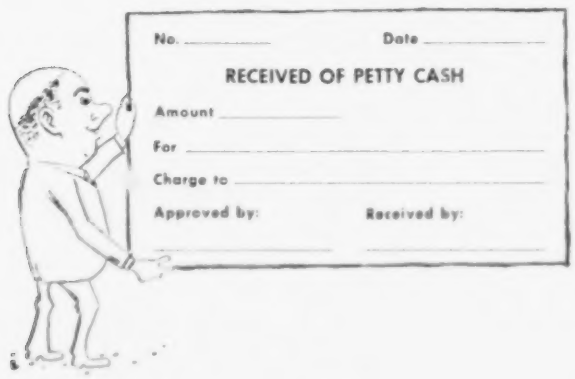
Cash to be deposited on the daily summary should always equal the total receipts to be accounted for minus the fixed amount of your petty cash and change funds. If it does not, all the work in preparing the daily summary should be carefully checked. Obviously, an error in giving change, in ringing up a sale, or neglecting to do so, will result in a cash shortage or overage. The daily summary provides spaces for such errors so that the proper entries can be made in your bookkeeping records. The last section of your daily summary, "Sales," records the total daily sales broken down into (1) cash sales and (2) charge sales.

As soon as possible after the daily summary has been completed, all cash for deposit should be taken to the bank. A duplicate deposit slip, stamped by the bank, should be kept with the daily summary as evidence that the deposit was made.

Petty Cash and Charge Funds

The record of daily sales and cash receipts which we have just described is designed on the assumption that a petty cash fund and a change cash fund, or a combination change and petty cash fund, are used. All businesses, small and large, have day-to-day expenses that are so small they do not warrant the drawing of a check. Good management practice calls for careful control of such expenses. The petty cash fund provides such control. It is a sum of money which is obtained by drawing a check to provide several day's, a week's, or a month's need of cash for small purchases. The type of business will determine the amount of the petty cash fund.

DOCUMENT YOUR PETTY CASH EXPENSES



Visual No. 4-13

Each time a payment is made from the petty cash, a slip should be made out. If an invoice or receipt is available, it should be attached to the petty-cash slip. The slips and the money ordinarily, but not necessarily, are kept separate from other currency in your cash till, drawer, or register. At all times, the total of unspent petty cash and petty cash slips should equal the fixed amount of the fund. When the total of the slips approaches the fixed amount of the petty cash fund, a check is drawn for the total amount of the slips. The money from this check is used to bring the fund back to its fixed amount.

In addition to a petty cash fund, some businesses that receive cash in over-the-counter transactions have a change fund. The amount needed for making change varies with the size and type of business, and, in some cases, with the days of the week. Control of the money in your change fund will be made easier, however, if you set a fixed amount large enough to meet all the ordinary change-making needs of your business. Each day, when the day's receipts are balanced and prepared for a bank deposit, you will retain bills and coins totaling the fixed amount of the fund for use the following day. Since you had that amount on hand before you made the day's first sale, the entire amount of the day's receipts will still be available for your bank deposit.

In some cases, the petty cash fund is kept in a petty cash box or safe, apart from the change fund. However, the same fund can serve for both petty cash and change. For example, if you decide that you need $50 for making change and $25 for petty cash, one $75 fund can be used. Whenever, in balancing the day's operations, you see that the petty cash slips total more than $25, you can write a petty cash check for the amount of the slips.

Record of Cash Disbursement

To safeguard your cash, it is recommended that all receipts be deposited in a bank account and that all disbursements, except those made from the petty cash fund, be made by drawing a check on that account. Your bank account should be used exclusively for business transactions. If your business is typical, you will have to write checks for merchandise purchases, employee's salaries, rent, utilities, payroll taxes, petty cash, and various other expenses. Your check stubs will serve as a record of cash disbursements.

The checkbook stub should contain all the details of the disbursement including the date, payee, amount and purpose of the payment. In addition, a running balance of the amount you have in your bank account should be maintained by subtracting the amount of each check from the existing balance after the previous check was drawn. If the checks of your checkbook are prenumbered, it is important to mark plainly in the stub when a check is voided for one reason or another.

Each check should have some sort of written document to support it--an invoice, petty-cash voucher, payroll summary and so on. Supporting documents should be approved by you or someone you have authorized before a check is drawn. They should be marked paid and filed after the check is drawn.

Periodically, your bank will send you a statement of your account and return cancelled checks for which money has been withdrawn from your account. It is important that you reconcile your records with those of the bank. This means that the balances in your checkbook and on the bank statement should agree. Uncashed checks must be deducted from your checkbook balance and deposits not recorded on the bank statement must be added to its balance in order to get both balances to agree.

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Accounts Receivable Records

If you extend credit to your customers, you must keep an accurate account of your credit sales not only in total as you have done on the daily summary but also by the amount that each individual customer owes you. Moreover, you must be systematic about billings and collections. This is important. It results in better relations with your charge customers and in fewer losses from bad debts.

The simplest method of handling accounts receivable--other than just keeping a file of sales-slip carbons--is to have an account sheet for each credit customer. Charge sales and payments on charge sales are posted to each customer sheet. Monthly billing to each of your charge customers should be made from their individual account sheets.

ACCOUNTS RECEIVABLE AGING SCHEDULE
THE BLANK COMPANY

CUSTOMER	TOTAL AMOUNT	CURRENT	30-60 DAYS	60-90 DAYS	3-7 MONTHS	7-12 MONTHS	OVER 1 YEAR
JOHN JONES	103.50	52.50	49.50				
SAM SMITH	23.00	23.00					
RICHARD ROE	9.75			9.75			
DAVID DOE	28.00	20.00			8.00		
JAMES JOHNSON	14.50					14.50	
WILLIAM WILLIAMS	35.00						35.00
TOTAL	450.00	336.50	72.75	5.00	16.00	5.00	10.00
PERCENT	100	75	16	1	4	1	3

Visual No. 4-14

At least two or three times a year, your accounts receivable should be aged. You do this by posting each customer's account and his unpaid charges in columns according to age. These columns are labeled: not due; 1 to 30 days past due; 31 to 60 days past due; 61 to 90 days past due; etc. This analysis will indicate those customers who are not complying with your credit terms.

Property Records and Depreciation

In every type of business, it is necessary to purchase property and equipment from time to time. This property usually will last for several years, so it would be unrealistic to show the total amount of the purchase as an expense in any one year. Therefore, when this property is set up in the books as an asset, records must be kept to decrease its value over its life. This decrease is known as depreciation. I have mentioned this before during this talk. The amount of the decrease in value in one year, that is, the depreciation, is charged as an expense for the year.

I am talking about this expense, particularly, because no cash is paid out for it. It is a non-cash, not-out-of-pocket expense. You don't have to hand over actual money at the end of the month.

Records should be kept of this because, otherwise, there is a danger that this expense will be overlooked. Yet it is impossible to figure true profit or loss without considering it.

When you deduct the depreciation expense from your firm's income, you reduce your tax liabilities. When you put this depreciation expense into a depreciation allowance account, you are keeping score on your "debt" to depreciation.

In a barber shop, to take a simple example, depreciation of its chairs, dryers, and clippers at the end of the year amounts to $136. You deduct this $136 from the shop's income, in this case, to pay the debt credited to your depreciation allowance account. Since this equipment has the same depreciation value each year, the depreciation allowance account at the end of 3 years will show that a total of $408 worth of equipment has been used up. The books of the barbershop therefore show an expense of $408 which actually has not been spent. It is in the business to replace the depreciated equipment. If replacement will not take place in the immediate future, the money can be used in inventory, or in some other way to generate more sales or profits.

How you handle this money depends on many things. You can set it aside at a low interest rate and have that much less operating money. Or you can put it to work in your business where it will help to keep your finances healthy.

Remember, however, that you must be prepared financially when it is time to buy replacement equipment. A depreciation allowance account on your books can help to keep you aware of this. It helps you keep score on how much depreciation or replacement money you are using in your business.

Keeping score with a depreciation allowance account helps you to know when you need to convert some of your assets into replacement cash. If, for example, you know on January 1 that your delivery truck will be totally depreciated by June 30, you can review the situation objectively. You can decide whether you ought to use the truck longer or replace it. If you decide to replace it, then you can plan to accumulate the cash, and time the purchase in order to make the best deal.

Schedule of Insurance Coverage

The schedule of insurance coverage is prepared to indicate the type of coverage and the amount presently in force. This schedule should list all the insurance carried by your business--fire and extended coverage, theft, liability, life, business interruption and so forth.

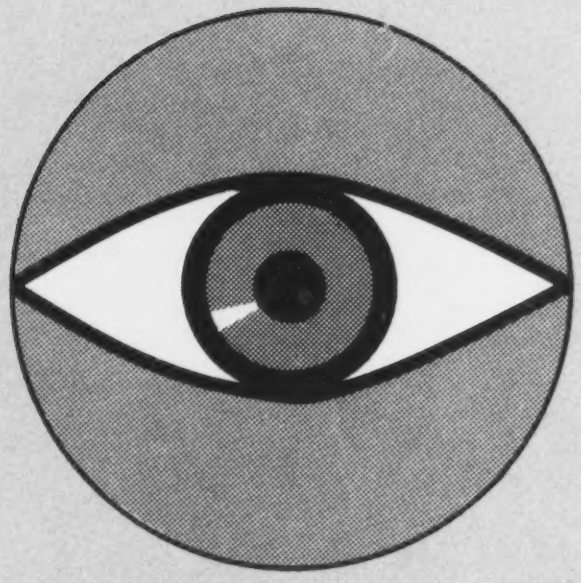
This schedule should be prepared to present the following: name of insurance company, annual premium, expiration date, type of coverage, amount of coverage, asset insured, and estimated current value of asset insured.

An analysis of this schedule should indicate the adequacy of insurance coverage. A review of this schedule with your insurance agent is suggested.

CONCLUSION

During the brief time allotted to this subject of "The Why and What of Bookkeeping," we have just scratched its surface. What we have tried to do is to inform you, as small-business managers, of the importance of good records. We have described the components of the important records that you must have if you are going to manage your business efficiently and profitably. In addition, we have brought to your attention some of the subsidiary records that will aid you in managing your business.

There are other records such as breakeven charts, budgets, cost accounting systems, to mention a few, which can also benefit the progressive manager. However, we do not have the time even to give you the highlights of those management tools. Your accountant can assist you in learning to understand and use them. Moreover, he can help you to develop and use the records we have discussed. For further information about them, you also can read the publications of the Small Business Administration, some of which are available to you free of charge (See Bibliography). By reading and using the accounting advice available to you, you can make sure that you have the right records to improve your managing skill and thereby increase your profits.



THE VISUAL AIDS

A What to Show

Section

The old Chinese proverb **"One See Worth Thousand Say"** is certainly borne out by experience in the fields of education and training at all levels.

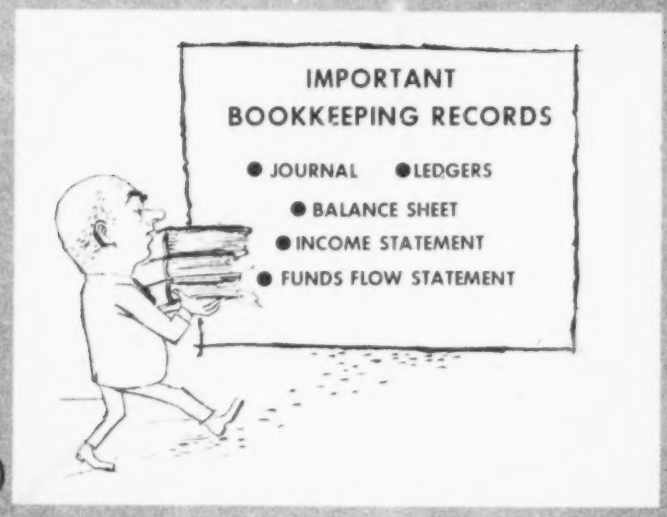
The instructor who helps his participants **visualize** subject matter and ideas not only holds the group interest--he also stimulates thoughtful consideration and retention of the topic.

This section contains samples of visuals that are available for this subject. Each has been carefully coded and "keyed" into **The Lesson Plan** as outlined in this manual.

USE OF VISUAL AIDS

WHAT TO USE	WHEN AND HOW TO USE
Chalkboard	Study and plan before a meeting what to put on the board and where to put it. Use it to present sketches, diagrams, outlines, definitions, key words, directions, record of class contributions, and summaries. Suit material to board space. Write plainly and quickly. Keep wording simple. Stand at one side of board while referring to material. Talk to the group, not to the board. Erase material no longer needed.
Posters, Charts, and Diagrams	To arouse interest and attract attention; to show relationships and trends; to inspire group. Use device large enough to be seen. Post where everyone can see. Present at right time. Discuss information illustrated.
Hand-Out Materials	To present information uniform in character and as a guide to material covered; emphasize key points; arouse interest and discussion; review or summarize discussions; and serve as permanent reference. Select to serve a definite purpose. Introduce at right time. Distribute in manner to convey its importance. Direct members how to use.
Films and Film Strips	Present an overall view; introduce a new subject; emphasize specific aspects of a subject; arouse interest; summarize. Select carefully to relate to the discussion and plan presentation. Arrange room and equipment for showing. Alert the audience for the showing or what will be seen. Run the film. Discuss the subject matter and summarize.
Samples, Forms, and Exhibits	Keep subject matter practical; show development of a process; increase understanding. Select only enough to illustrate, not confuse. Pass around if necessary. Take time to present clearly. Comment when presenting.
Pedestal Chart	A pad of newsprint sheets or similar paper may be used for the same purposes as the chalkboard. Material recorded with chalk or crayon may be saved for future reference by the group or by the instructor.

OVERHEAD PROJECTUALS



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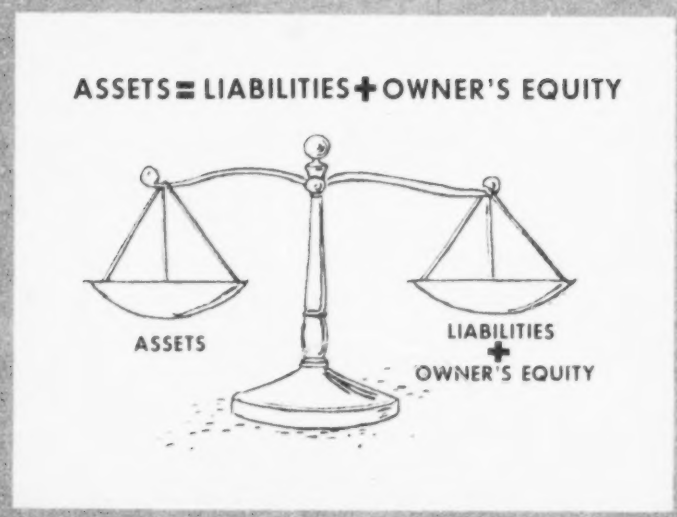

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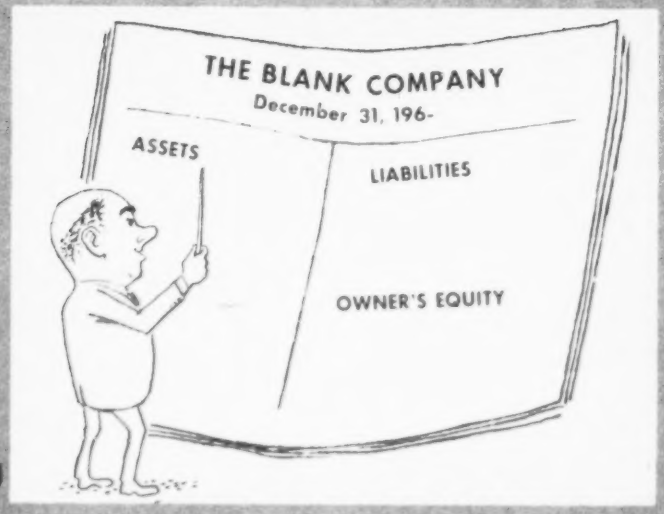

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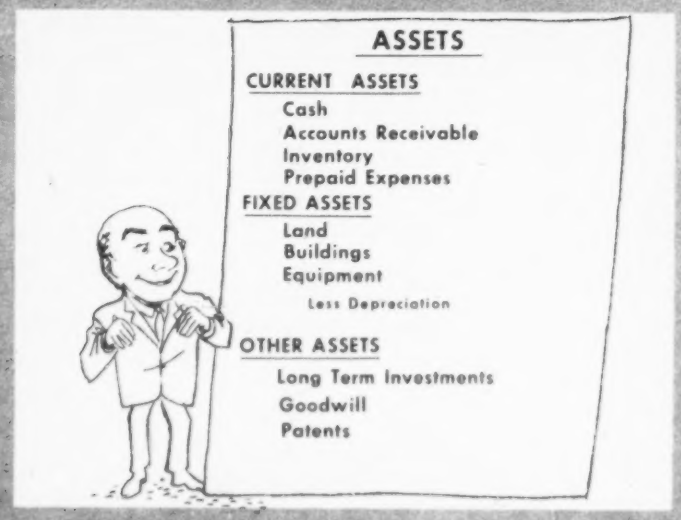

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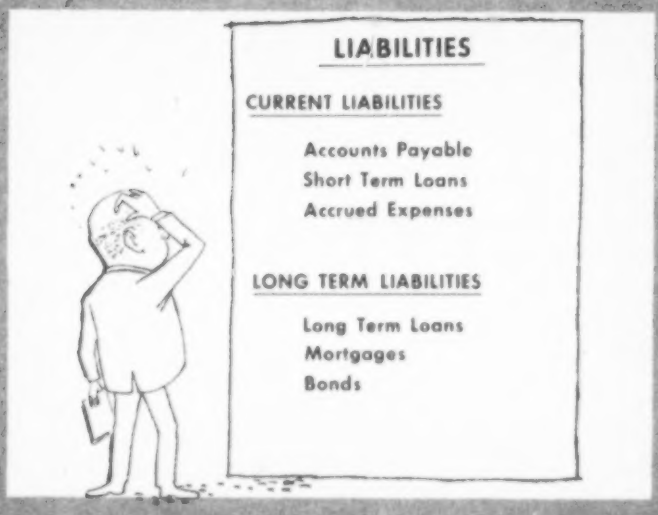

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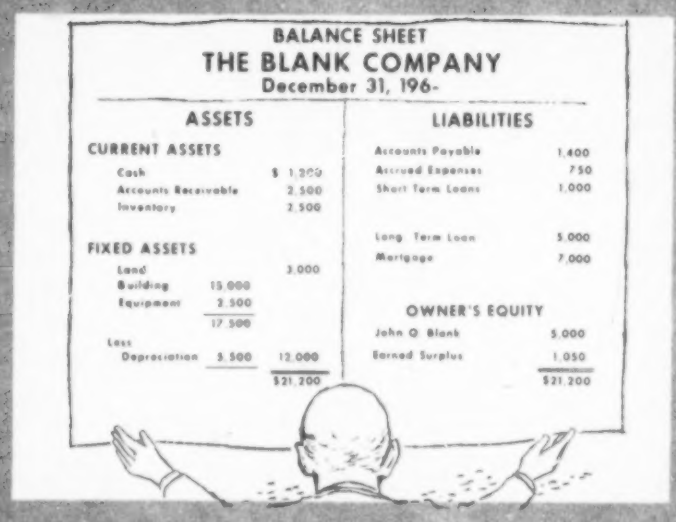

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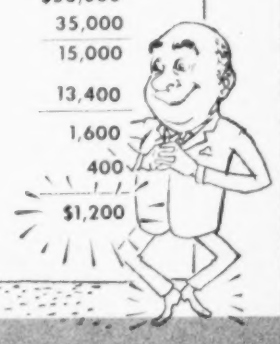
OVERHEAD PROJECTUALS

INCOME STATEMENT
THE BLANK COMPANY
January 1, 196- to December 31, 196-

SALES	$50,000
COST OF GOODS SOLD	35,000
GROSS MARGIN	15,000
EXPENSES	13,400
PROFIT BEFORE TAXES	1,600
TAXES	400
NET PROFIT	$1,200



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COST OF GOODS SOLD

BEGINNING INVENTORY		$ 2,400
PURCHASES	+	35,100
GOODS AVAILABLE FOR SALE	=	37,500
ENDING INVENTORY	−	2,500
COST OF GOODS SOLD	=	$35,000

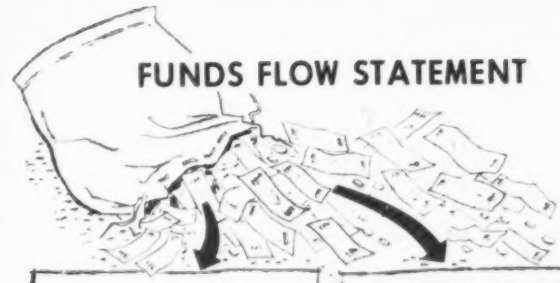
8

EXPENSES

SALARIES & WAGES	$5,500
UTILITIES	500
DEPRECIATION	875
INTEREST	600
INSURANCE	100
ADMINISTRATIVE EXPENSE	5,000
SUPPLIES	125
BAD DEBT EXPENSE	100
ADVERTISING	250
STATE, LOCAL & EXCISE TAXES	350
TOTAL EXPENSES	$13,400

9

FUNDS FLOW STATEMENT



USES OF FUNDS
- INCREASE IN ASSETS
- DECREASE IN LIABILITIES

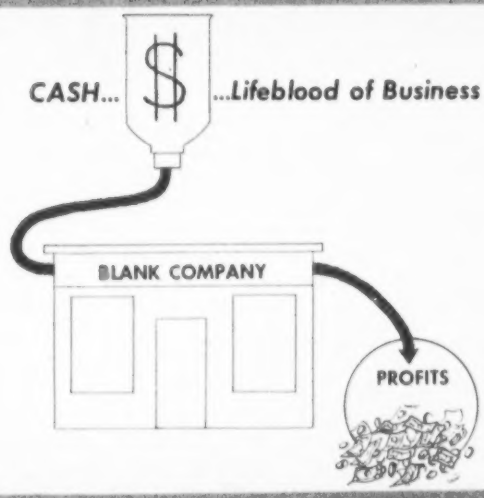
SOURCES OF FUNDS
- DECREASE IN ASSETS
- INCREASE IN LIABILITIES
- INCREASE IN OWNER'S EQUITY

10

COMPARISON OF SELECTED BALANCE SHEET ITEMS
THE BLANK COMPANY

	LAST YEAR	THIS YEAR	SOURCE OF FUNDS	USE OF FUNDS
ASSETS				
CASH	1500	1200	300	
ACCOUNTS RECEIVABLE	2200	2500		300
INVENTORY	2300	2500		200
EQUIPMENT	2000	2500		500
LIABILITIES				
ACCOUNTS PAYABLE	1000	1400	400	
LONG TERM LOANS	5000	5000		
MORTGAGE	8000	7000		1000
OWNER'S EQUITY				
JOHN Q. BLANK	4500	5000	500	
EARNED SURPLUS	250	1050	800	

11



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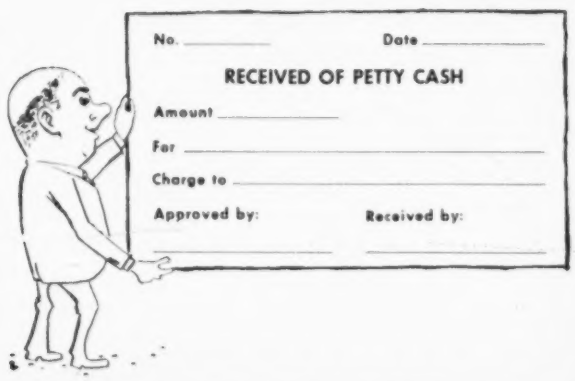
OVERHEAD PROJECTUALS

DOCUMENT YOUR PETTY CASH EXPENSES



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ACCOUNTS RECEIVABLE AGING SCHEDULE

THE BLANK COMPANY

CUSTOMER	TOTAL AMOUNT	CURRENT	30-60 DAYS	60-90 DAYS	3-7 MONTHS	7-12 MONTHS	OVER 1 YEAR
JOHN JONES	103.50	52.50	49.50				
SAM SMITH	23.00	23.00					
RICHARD ROE	9.75			9.75			
DAVID DOE	28.00	20.00			8.00		
JAMES JOHNSON	14.50					14.50	
WILLIAM WILLIAMS	35.00						35.00
TOTAL	450.00	336.50	72.75	5.00	16.00	5.00	10.00
PERCENT	100	75	16	1	4	1	2

14

THE SUPPLY DEPARTMENT

A Resource Materials and Participant Handout

Section

It is generally conceded that interest intensifies in situations where people have a chance "to participate" by such means as open discussion and buzz sessions. The materials in this section should prove useful in this kind of activity. These materials may be reproduced locally.

It is also desirable to provide participants with "take away" materials if they are pertinent and concise. Accordingly, appropriate Management Aids, Small Marketers Aids, and Management Research Summaries are included in this section. Current information on the availability of suggested and new SBA publications may be obtained from the nearest SBA office.

BALANCE SHEET

THE BLANK COMPANY

December 31, 196-

ASSETS

CURRENT ASSETS

Cash	$ 1,200
Accounts Receivable	2,500
Inventory	2,500

FIXED ASSETS

Land		3,000
Building	15,000	
Equipment	2,500	
	17,500	
Less Depreciation	5,500	12,000
		$21,200

LIABILITIES

Accounts Payable	1,400
Accrued Expenses	750
Short Term Loans	1,000
Long Term Loan	5,000
Mortgage	7,000

OWNER'S EQUITY

John Q. Blank	5,000
Earned Surplus	1,050
	$21,200

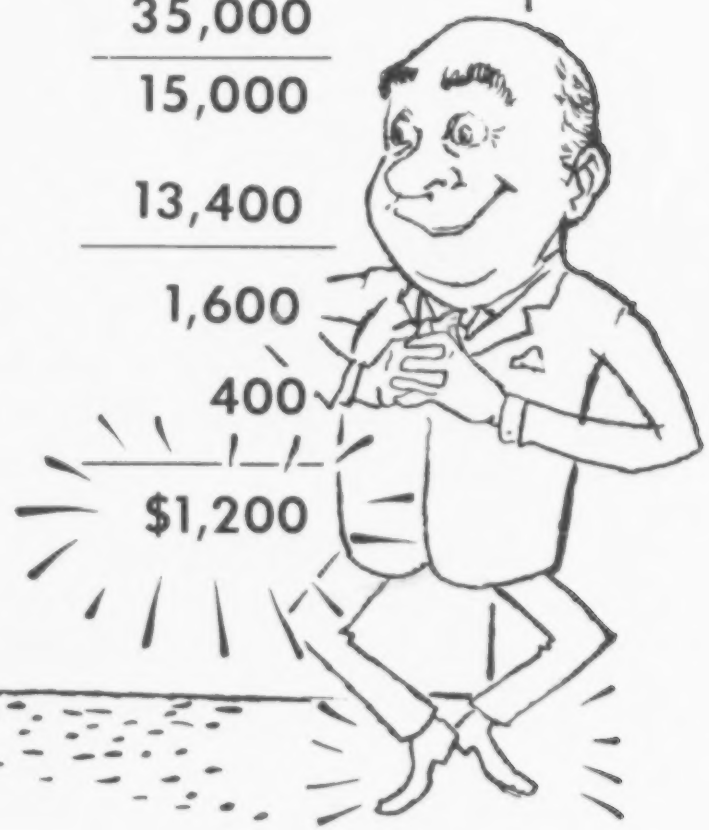
Handout No. 4-1

INCOME STATEMENT

THE BLANK COMPANY

January 1, 196- to December 31, 196-

SALES	$50,000
COST OF GOODS SOLD	35,000
GROSS MARGIN	15,000
EXPENSES	13,400
PROFIT BEFORE TAXES	1,600
TAXES	400
NET PROFIT	$1,200



Handout No. 4-2

DAILY SUMMARY OF SALES AND CASH RECEIPTS

Date _____

CASH RECEIPTS

1. Cash sales . . . . . $_____
2. Collections on account . . . . . $_____
3. Miscellaneous receipts . . . . . $_____
4. TOTAL RECEIPTS TO BE ACCOUNTED FOR . . . $_____

CASH ON HAND

5. Cash in register or till:
   - Coins . . . . . $_____
   - Bills . . . . . $_____
   - Checks . . . . . $_____
   - Total cash in register or till. . . . . $_____
6. Petty-cash slips . . . . . $_____
7. TOTAL CASH ACCOUNTED FOR . . . . . $_____
8. Less change and petty-cash fund:
   - Petty-cash slips . . . . . $_____
   - Coins and bills . . . . . $_____
   - Change and petty-cash fund (fixed amount). . $_____
9. CASH TO BE DEPOSITED . . . . . $_____
10. CASH SHORT (Item 4 less item 9 if item 4 is larger) $_____
11. CASH OVER (Item 9 less item 4 if item 9 is larger). $_____

SALES

12. Cash sales . . . . . $_____
13. Charge sales (sales checks #___ to #___) . . . . . $_____
14. TOTAL SALES . . . . . $_____

By _____

Handout No. 4-3

IMPORTANT BOOKKEEPING RECORDS

- JOURNAL
- LEDGERS
- BALANCE SHEET
- INCOME STATEMENT
- FUNDS FLOW STATEMENT

OTHER RECORDS

- Daily Summary of Sales and Receipts
- Bank Checkbook
- Accounts Receivable Aging Schedule
- Equipment Record
- Insurance Register

SMALL BUSINESS ADMINISTRATION

Topic 4

Focal Points on

The WHY and WHAT of BOOKKEEPING

This page and the following illustrate a two-fold leaflet which summarizes the subject presentation. The leaflet is available in quantity from the nearest Small Business Administration office for distribution to participants in SBA-cosponsored administrative management courses.

INCOME STATEMENT

NET SALES

COST OF GOODS SOLD

GROSS MARGIN

EXPENSES

- RENT
- WAGES
- UTILITIES
- SUPPLIES
- ADMINISTRATIVE EXPENSES
- DEPRECIATION
- INTEREST

PROFIT BEFORE TAXES

TAXES

NET PROFIT

BALANCE SHEET

CURRENT ASSETS

CASH

ACCOUNTS RECEIVABLE

INVENTORY

FIXED ASSETS

LAND

BUILDING

EQUIPMENT

LIABILITIES

ACCOUNTS PAYABLE

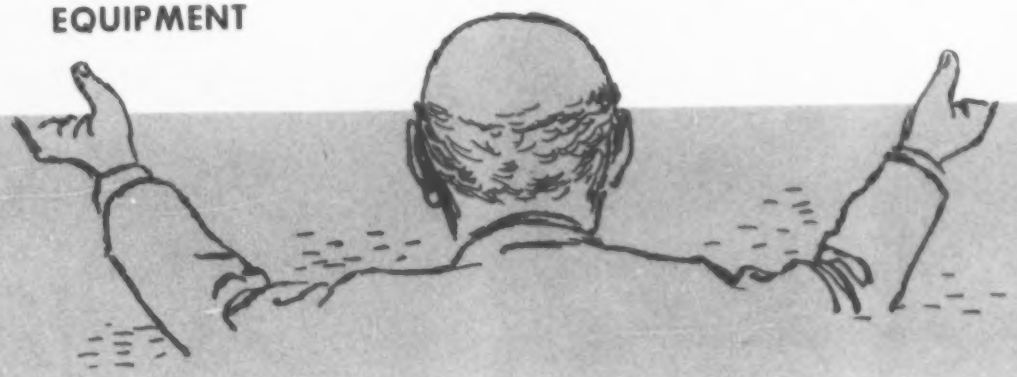
ACCRUED EXPENSES

SHORT TERM LOANS

LONG TERM LOANS

MORTGAGE

OWNER'S EQUITY



SMALL BUSINESS ADMINISTRATION
U. S. Government Agency

SMALL MARKETERS AIDS No. 94

Washington, D.C.

KEEPING SCORE WITH EFFECTIVE RECORDS

By William L. Raby

Associate Professor of Accounting, College of Business Administration, Ohio University, Athens, Ohio; partner, Goldstein, Kramer, Smith, and Raby, Certified Public Accountants, Tucson, Arizona

SUMMARY

This Aid is designed for small marketers who may wish to check their records. To be effective, records should provide needed facts at the proper time, and they should be easy to handle. The kinds of records and how many depend on the nature of the particular business.

Records are effective when they tell you the score on your business and thus help you to keep out of trouble. Sometimes trouble comes because a small marketer lacks the records necessary to support statements made on tax forms. More often, though, trouble comes because the small marketer's recordkeeping does not give him the facts he needs for making sound decisions.

Records can take many forms and can help you in carrying on your management activities, such as, buying, selling, planning, and taxes. What kinds of records and how many depends on the nature of your operation. For example, the part-time marketer who sells hot dogs at the ballpark has little need for inventory records. He buys only enough merchandise--weiners and buns--for one game. Yet small retailers of piece goods, shoes, and other types of merchandise need some sort of stock control records because they cannot possibly keep such information by memory alone.

In this Aid, records are grouped according to their use. None of them will be applicable to all businesses. In fact, you may need only a few of them in your operation. This Aid is designed, then, only to call your attention to the one or two records which you may have overlooked but could use to great advantage. The last section--"Wasted Motion?"--lists questions which may be helpful in checking your recordkeeping methods. To be effective, records should do two things: (1) provide the needed facts on a timely basis and (2) lend themselves to efficient handling. These two objectives should set the form which your records take.

INVENTORY AND PURCHASING

(These records provide facts needed for buying and selling.)

Inventory Control Record--USE: Essential to making buying-and-selling decisions. Some firms control their stock by taking physical unit inventories frequently. Others use dollar inventory records which give a rough idea of what their inventory (based on gross profit margins) may be from day-to-day in terms of dollars. Firms with thousands of different items (drugstores, for example) find dollar inventory records easier to use than physical inventory control. Such records give them their total inventory in dollars.

Item Perpetual Inventory Record--USE: Provides a ready balance of stock on hand. Some firms selling big ticket items use an inventory card for each class of items. They post details of merchandise received and sold on it. They check the accuracy of the balance shown on the cards by making periodic spot checks of the number of units in the stockroom.

Model Stock Plan--USE: Provides a record of basic stock in sizes, colors, types, prices, and amounts. It is sometimes called the "never-out-list".

Out of Stock Sheet (sometimes called a "want" sheet)--USE: Notifies buyer that certain items need to be reordered. Items in low supply should be listed early enough to allow time for delivery before the stock is exhausted.

"Open-To-Buy" Record--USE: Helps you to prevent overstocking by adjusting purchases to sales. This record is a running account of the dollar amount that may be bought without jeopardizing the inventory position which you try to maintain.

Purchase Order File--USE: Tells what has been ordered and its status (for example, in transit, expected in 15 days, and so on). Some firms keep this file by using a carbon copy of each purchase order on which they jot down the expected delivery dates, changes, and so on.

Open Purchase Order File--USE: Helps you to tell whether shipments are coming through on time. This file is particularly helpful for merchandising fashion items, replacement parts, and merchandise involving timing. Some merchants make up an extra copy of their purchase order and use it for this file.

Supplier File--USE: Provides a handy reference on your suppliers; helpful when negotiating with a supplier because you can quickly figure the annual amount of business you do with him. You can set up this file by using extra copies of your purchase orders and filing them by suppliers.

Returned Goods File--USE: Provides a record of merchandise returned to supplier by dates, amounts, and reasons. Helps to facilitate payments and control quality.

Price Change Book--USE: To record markdowns and markups by dates, amounts, and percentages.

SALES RECORDS

(They give you facts which you can use to determine sales trends.)

Record of Individual Sales Transactions--USE: Helps you to account for the outward flow of goods. You should have a sales slip or a cash register tape record for all merchandise leaving your store. Sales slips should be prenumbered and each number accounted for.

Summary of Daily Sales--USE: Helpful in figuring trends in sales (seasonal, weekly, and so on). This summary (by salespeople or types of merchandise) makes up the record of sales for accounting purposes.

Operating Plan--USE: Provides goals for your operation during a certain period of time--week, month, or season. You project what you plan to do during the coming period (before that period starts) in terms of sales (broken down into classes that are significant for your operation) and what expenses (fixed, controllable, and discretionary) will be. By these forecasts, you can estimate your financial position in terms of cash, receivables, inventory, and payables at the end of the period.

Operating Summary--USE: Provides a basis for determining whether your operating plan was successful. The operating summary compares what actually happened during the period with the goals you set up before the period started. The summary should include the same items as those in your operating plan.

Sales Promotion Plan--USE: To plan, coordinate, and control sales promotion activities, such as, advertising, display, and special events.

Accountability Records--USE: Shows how your firm is making or losing money. By subtracting the cost of sales (the cost of the items sold) from your sales for that month, you get your gross profit. From this gross, you subtract other expenses to get your net profit before taxes. By breaking your profit and loss statement down by departments or by significant types of merchandise, you can determine whether a department or a type of goods is paying its way in terms of space occupied, the work involved, and other costs. Some firms go a step further and make up a P&L statement on each salesperson. (For additional information see: "Responsibility Accounting Can Pay Dividends" in *Management Aids for Small Manufacturers Annual* No. 8. Small Business Administration, 1962. 35 cents. Superintendent of Documents, Washington, D.C. 20402.)

CASH RECORDS

(These records tell what is happening to your cash.)

Daily Cash Reconciliation--USE: Provides data (in summary form) for entry in cash receipts journal. These data are picked up from cash register tapes (or other sources of cash receipts information) and are reconciled according to the beginning-of-day and the end-of-day balance changes and bank deposits.

Cash Receipts Journal--USE: Lists all the cash coming into your business and its source. The amounts entered in this journal should be deposited intact in the bank. Never use cash receipts for paying small bills. Pay them by check or with money from your petty cash fund.

Bank Reconciliation--USE: Necessary for determining whether your firm's checkbook agrees with the bank's records. You or some trusted person who does not have access to your cash receipts or checks should get the monthly bank statement and prepare the reconciliation. The reconciled bank balance should be checked with both your bank book and with your general ledger account for cash in bank.

CREDIT

(Credit records help you to keep track of who owes you and whether they are paying up on schedule.)

Charge Account Applications--USE: Helps you to decide whether to extend credit to a customer. This form shows the customer's place of employment, his bank, and other pertinent information. It should also indicate his credit limit.

Accounts Receivable Aging List--USE: Shows length of time that customers are delinquent and helps you to tell which ones may become bad debts. This sheet lists in one column the receivables dating from the past month to the current month and shows the total balance for each customer. The portions of the

total which are from the previous month, the month before that, and so on are shown in appropriate columns. These are your potential bad debts.

EMPLOYEES

(Some small business owners find that certain kinds of personnel records are helpful in the efficient management of their personnel.)

Record of employee earnings and amounts withheld (by months, quarters, and for each year)--USE: Essential in preparing payroll tax returns and furnishing employees with required Forms W-2 (Withholding Tax Statement) and corresponding State forms. This record should also show the amounts withheld for Social Security.

Employee's Withholding Exemption Certificate (Form W-4)--USE: Supporting record for the withholding exemptions taken by your employees. The law requires employees to file new exemption certificates once a year, if there has been a change in their exemption status.

Record of Hours Worked (each day by each nonexecutive employee)--USE: To prove your compliance with the law on minimum wages and overtime. Also useful in keeping track of absences caused by illness, vacation time, tardiness, and payroll costs.

Record of Expense Allowances (and reimbursements paid yourself and employees who incur expenses in connection with their jobs)--USE: To help in budgeting and controlling personnel expense allowance and to support income tax deductions.

Employment Applications--USE: To provide a permanent record on each applicant that was hired. They can be used also to prove good faith when employment of under-age persons is alleged.

Record of Changes in Rate of Pay--USE: To show the nature of the change, authorization, and reason.

Record of Reasons for Termination of Employment--USE: For contesting unwarranted claims for unemployment compensation; and for answering personal reference checks by future employers. Some firms include this record on the employment application form which they file as "inactive" when the person is no longer employed.

Record of Employee Benefits--USE: For reviewing what you spend for benefits for each employee, such as group hospitalization, life insurance, retirement, paid holidays, paid vacations, and so on.

Job Descriptions (for each job)--USE: Provide a list of the qualifications you need in an employee, are useful in training new employees; and can help to prevent confusion by spelling out what is done by whom.

Crucial Incidents Record (for each employee)--USE: Helpful in reviewing an employee's progress or when considering pay changes or promotions because this record describes briefly the unusual (good or bad) things which the employee has done at his job.

FIXTURES AND PROPERTY

(One of these records helps you to keep the facts needed for taking your depreciation allowances. The other is useful in keeping track of insurance coverage and claims.)

Equipment Record--USE: Essential for preparing income tax returns, if you wish to take advantage of depreciation deductions. It shows the nature of each piece of equipment, the date you acquired it, its cost, estimated life, and method of depreciation.

Insurance Register--USE: Helpful when filing claims for losses and when reviewing (annually) insurance coverage with a qualified insurance adviser. This register shows policy numbers, companies, kind and amount of coverage, expiration dates, and premiums.

BOOKKEEPING

(The kind of bookkeeping system you use depends on your situation. The records described below assume the use of a double entry system.)

General Journal--USE: Facilitates posting to control accounts, provides a catch-all for small daily transactions, and is essential to record closing entries when balancing accounts.

General Ledger--USE: Provides information by containing account sheets for the various asset, liability, ownership, expense, and revenue accounts. This ledger should be cross-referenced to their sources in the journal or journals (See descriptions below).

Accounts Receivable Ledger Sheet--USE: Helpful in reviewing the status of accounts because it shows how much credit was extended and how payments are being made. It facilitates the "aging" (scheduling your collection followup) of accounts.

Cash Disbursement Journal--USE: Necessary for controlling the outward flow of your cash. In this journal, you record all checks issued and their purpose. You handle your petty cash disbursements by writing a check to reimburse the petty cash fund for the exact amount that has been spent.

WASTED MOTION?

So far you have been checking kinds of records--ones which will provide the type of facts necessary to showing you the score on your business. This is one part of effective recordkeeping. Another part is the efficient handling of the records you decide to keep.

The following questions are designed to help you check your methods for handling records.

783-723 O-65-4

Your goal should be to record facts as easily and quickly as possible. As you study these questions, they may suggest others which could be helpful in finding and eliminating any wasted motion that might have crept into your recordkeeping.

In preparing monthly statements to send to customers, do you use antiquated methods, such as copying from a ledger card? Some stores save time and work by preparing such statements and ledger cards at the same time, one being a carbon copy of the other. Other stores attach copies of sales tickets to the statement which shows only the total charges for the month and the customer's balance.

Are you handling payroll data more than once? Do you, for example, record payroll data in a payroll journal, then write it on a payroll check stub, and finally write it again on an individual employee record? The use of an inexpensive one-write system will enable you to handle the payroll journal, check stub, and employee ledger in one operation.

Do you maintain unnecessary ledger records of your accounts payable? Many small marketers have found that a file of unpaid bills works as well, and requires less clerical effort. Check with your accountant on the advantages of the voucher system for handling payables.

Are you missing the boat in the use of punched paper (cash register) tape for use in sales and other analyses? Punched tape attachments for cash registers and adding machines are helping to bring electronic recordkeeping within the reach of small marketers. This tape which is a byproduct of regular operations can be processed at an information processing center. (For additional information, see: "Electronic Recordkeeping for Small Marketers," *Small Marketers Aids* No. 84, available free from the Small Business Administration.) Your accountant can explain how you might use these devices to make your records more useful.

Are old records cluttering up your storage space? Not all records need to be saved forever. Work out a record retention program with the help of your accountant and your attorney, and then destroy records in accordance with that program. You may want to check out the possibilities of putting some records--ones which the law requires--on microfilm. (For additional information see "Records Management in Smaller Stores" in *Small Marketers Aid Annual* No. 1. Small Business Administration. 1959, 45 cents. Superintendent of Documents, Washington, D.C. 20402.)

Accounting

SMALL BUSINESS ADMINISTRATION

SMALL MARKETERS AIDS No. 25

Washington 25, D. C.

ARE YOU KIDDING YOURSELF ABOUT YOUR PROFITS?

By *Fredrick G. Disney*, Management Consultant, Fort Worth, Texas

SUMMARY

Net profit is probably the most important indicator of the success of a business operation. Hence you should be concerned about the reliability of that figure. You can be surer of its accuracy by understanding the principal ways in which profits can be erroneously stated. Basically, there are four areas in which you can kid yourself about your profits.

1. ***The Existence of a Profit.*** Key question: Are such items as depreciation and inventory handled realistically in the accounting system?

2. ***The Sufficiency of the Profit.*** Key question: Although you may be making a profit, can it be considered sufficent for your size and type of operation?

3. ***The Profit Mix.*** Key question: Although you may be showing a good profit from your total operation, are there lines or departments in the company which are actually losing money?

4. ***The Profit Trend.*** Key question: Does the trend of profit show healthy progress, or is the tendency towards less and less profit?

To judge your own position in these areas, get appropriate help and guidance from your accountant or auditor. If your present information is not adequate for such an analysis, you should develop suitable records as soon as you can.

Basic to accurate profit determination is a system of accurate and meaningful accounting. The words *accurate* and *meaningful* are very significant because not all accounting systems convey a realistic picture of the results of operations. Although the proper mechanics of accounting may assure a balancing of debits and credits, this procedure will not of itself tell the whole profit story. Such information must be interpreted to provide the manager with a sound basis on which to direct future operations.

To be sure, consideration of the accounting procedures is necessary, since a figure of net profit has to be derived from some system. However, to managers, the detailed procedures of bookeeping are of little interest as compared to the ways these techniques can be applied to policy decisions.

There are four major areas in which you can kid yourself about your profits. They are: (1) The existence of a profit, (2) the sufficiency of the profit, (3) the profit mix, and (4) the profit trend.

THE EXISTENCE OF A PROFIT

A good first question to ask is: "Do I actually have a real profit?" You must realize that a final answer to this question is not necessarily indicated by the figure of "Net Profit" shown on the profit-and-loss (P and L) statement. To make sure that you are not being misled by this figure, you must analyze the basis of it.

● ***Analyzing the Basis of Net Profit.*** An orderly procedure is to start at the top of the P and L statement and compare every item with its counterpart in several other operating periods. A questioning attitude about each figure on the statement will help you to evaluate the true situation. You should not accept figures at their face value, but rather look behind the scene of each one to ferret out any hidden meanings.

● ***A Word About Profit and Loss Statements.*** There are two principal methods of reporting income and expenses on the P and L statement - - *the Cash Method* and *the Accrual Method.* The cash method shows only the actual receipt of cash (income), and the actual expenditures of cash (expenses). The accrual method reflects business transactions which took place during the reporting period whether or not any money, as such, changed hands. These two methods can convey totally different pictures of profit.

The cash method is usually not a reliable picture of income and expenses for the period covered by the P and L. The reason is that credit business comprises over 90 percent of all commercial transactions. Thus, a P and L reflecting only cash transactions will not account for much of the business applicable to the period. The accrual method, however, *can* account for all activities, cash or credit, completed during the period.

● ***Sales.*** Some accounting procedures do not go to the extent of determining *net* sales (generally the gross sales less returns and allowances). Try to make sure, therefore, that "sales" figures reflect the actual, final sales which took place in the period covered by the P and L.

● ***Cost of Goods Sold and Inventory Valuation.*** Cost of goods sold, the next item after Net Sales on the P and L, is determined by subtracting the inventory at the end of the period from the total obtained by adding the inventory at the beginning of the period to purchases made during the period. (Note: Beginning inventory and purchases are often referred to as "merchandise available for sale.") Sometimes this method of inventory valuation can be the cause of significant distortion in the profit picture. If, for instance, the closing inventory were valued high, the cost of goods sold would be lower and profits would be higher. Thus, the cost-of-goods-sold figure easily can be distorted by any change in the method of inventory valuation, or by failure to observe sound valuation methods.

Each manager should review his own inventory procedures to determine, first, what basis is used, and second, if this basis reflects the most realistic value of the stock on hand.

● ***Depreciation.*** One of the most critical areas in the over - or understatement of profits is that of depreciation. Here is a specific area wherein you can be misled by what appears to be a sound and accurate accounting procedure. For one thing, the depreciation account can show a record of depreciation down to the exact penny. These entries in this account give the impression of absolute accuracy. Because of this you can easily lose sight of the fact that the human judgment which established the original depreciation rate could have been in error - - sometimes in gross error.

By way of illustration, the decision to depreciate some store fixtures over a period of 10 years by one company proved to be unrealistic since it was found that these items had actually reached the limits of their usefulness and needed to be replaced at the end of 6½ years. Hence for 6½ years the owners of that company had been kidding themselves about the amount of their profit.

You should carefully review depreciation policies in terms of your past experience, good judgment, and the experiences of the trade. The tax rules of the Internal Revenue Service inform you of legal limitations and serve as a basis for the determination of a realistic depreciation policy. They can be a useful guide. However, in new situations it is often desirable to work out depreciation schedules through detailed discussions with Internal Revenue authorities as to what is reasonable.

In addition to making certain that your depreciation policies are realistic, you also shold determine whether all depreciable items are included in your depreciation schedules.

● ***Failure to Prorate Annual and Quarterly Expenses Each Month.*** Companies kid themselves about their monthly profits when they do not take into account charges and expenses which arise only annually. In many smaller businesses these items are not considered until they arise at the end of the year, often to the disillusionment of the manager. Such omissions are particularly noticeable in job estimations and pricing in job-shop operations. The manager thinks he is figuring jobs on the basis of a good profit but finds that his total operating expenses should have included a number of items he actually failed to consider in the day-to-day job estimations.

Some examples of these expenses are:

(1) Income taxes
(2) Insurance premiums
(3) Rent (if paid quarterly or annually)

● ***Maintenance and Upkeep Expenses.*** Another expense allied to the annual and quarterly expenses discussed above is that for facilities and equipment maintenance. The monthly P and L statement may fail to carry an allowance for this expense for some months. In that case the profits for those months will have to be readjusted when large repair bills fall due. Sometimes these bills can be large enough to wipe out profits for several months.

● ***Low Salary for the Owner-Manager.*** Many small businesses which appear to be making a fairly good profit would find a changed situation if they allowed a comfortable salary for the owner-operator. Often the proprietor draws money out of the business on an irregular basis, as he needs it. Many times this does not amount to reasonable compensation when compared with the pay of other similar managers working on a regular salary basis.

For example, total withdrawals for a year by one owner-operator amounted to $8,000, but the going pay for comparable work was actually $15,000 a year. Consequently $7,000 of the profit figure was the result of the fact that the owner

was underpaid by that amount. If he had had to withdraw from the business and hire someone to perform his job, he would have had to pay at least $15,000.

Often a manager will not recognize that fact until he approaches his bank for a loan. In examining the company's financial statements, the banker will recognize that the profit figure is not so much a result of profitable business operation as it is of working for an unrealistic salary. Of course, when thus done intelligently and deliberately, as a means of building up capital funds in a new enterprise, most bankers would not criticize.

● ***Lack of Sufficient Insurance Coverage.*** The profit figure can also contain amounts which are brought about as the result of unjustifiable risk-taking by the business. Serious fires or other accidents, if not covered by adequate insurance protection, can cause a drain on resources that may wipe out much or all of the profits for the past year or so. When a company has been carrying insufficient insurance coverage to guard against such disastrous experiences, somewhat more profit will be shown from month to month. In such cases the profit figure can be said to be a combination of the results of profitable operation, plus false savings brought about by undue risk taking. Just how much protection is "adequate" is, of course, a matter of judgment. For advice on this point consult your insurance agent, broker, or company representative, and your accountant or banker.

● ***Minimum Wage Laws.*** With the current emphasis on compliance with the minimum wage law it is increasingly important for you to clarify the status of your company in this connection. Therefore, make sure you are not kidding yourself with inflated profits resulting from paying your employees a lower rate than is required.

THE SUFFICIENCY OF THE PROFIT

Although you may have determined that you actually have a profit, you may be kidding yourself as to the sufficiency of that profit. You may fancy yourself as a fairly efficient operator since you are showing what you consider a very respectable total dollar profit. However, you may actually be operating below par as compared to others performing the same or similar types of marketing operations. The point on which you may be kidding yourself is judging your profits against too low a standard. This will naturally make them look good.

In order to get a reliable perspective in this regard, you must reexamine your standard and establish a sound basis for comparison. If you establish a standard that represents real accomplishment, your comparisons will be valid.

A good procedure in this connection is to gather some statistics on the trade you are in as well as data on some of the most successful companies in that trade. Trade associations and publications are helpful sources of this information. One well-prepared set of figures is "The 14 Important Ratios" of Roy A. Foulke. These are published by Dun and Bradstreet, Inc., 99 Church Street, New York 8, N. Y., in a small volume revised each year. In addition to showing "Net Profits on Net Sales" for a number of businesses, this publication shows 13 other bases for measuring operations. Another good source is the continuing series of *Statement Studies* published annually by Robert Morris Associates, Philadelphia National Bank Bldg., Philadelphia 7, Pa.

THE PROFIT MIX

Although you find that you are making a real profit and that your profit is sufficient as compared to a good cross section of other similar concerns, there is another area in which you may be kidding yourself. It is in assuming that the total profit figure depicts the true situation for all the various lines or services of the company. Upon careful examination you may find that some activities are doing exceedingly well and even carrying other losing activities.

If your company is engaged in selling a number of products, providing a number of services, or engaged in a combination of these activities, you should develop a system for constantly determining the actual contribution of each of these goods, services, or activities to the total profit. There are, of course, cases where you may have to continue to handle certain losing items because they must be provided to complete your line of merchandise or service. If possible it is desirable to avoid this situation. But regardless of whether you can avoid them or not, you certainly should know specifically *what* activities are losing, *how much* they are losing, and *why* they are losing.

This information can be determined by a careful breakdown of income and expenses by individual line. The objective of this kind of "costing" is to allocate to each activity the costs required to carry it on. Typically, the costs will fall into three main categories:

(1) Wages
(2) Merchandise
(3) Overhead

Systems of costing need not be elaborate nor complicated, nor is it always necessary to carry on the procedures constantly. Periodic checks will often suffice.

THE TREND OF PROFIT

You may be satisfied with your analysis of the existence of a profit, the sufficiency of the profit, and the profit mix, and even then kid yourself in still another area. That is in the trend of your profit. The examination of your profit picture at any one point in time, such as a monthly or a yearly P and L statement might prove satisfactory. But when viewed in relation to a number of months or years it might instead show an unsatisfactory trend.

This comparative analysis might reveal such things as an increase in volume, but a decrease in the ratio of net profit to sales. Or expenses might be increasing at a faster rate than sales or net profit. Comparisons of this sort usually become more meaningful when all items are reduced to a percentage basis. Typically, all items are expressed as a percentage of net sales.

Many small marketers find return on investment to be a useful yardstick for measuring the trend of their profits. It is not difficult to develop and apply. Essentially it tells you two things: How well your firm did in one reporting period in contrast with others, and how much the money invested in your business earns in comparison with other investment alternatives.

For example, suppose you had a small service business in which capital of $38,000 had been invested. And suppose you felt that, all things considered, the yield on that capital should be about 9 percent a year before taxes. This would total $3,420.

That figure might work out to, say, 3 percent of annual net sales of $114,000. Therefore, to keep track during the year of how things were going--the trend, in other words--you might keep score, on a quarterly basis, of sales and profits. Any quarter ending with sales of less than $28,500 and profits below $855 would indicate that things were moving in the wrong direction.

Knowing that, you could try either to increase sales volume to produce more profit dollars, or to obtain better margins on existing volume. If neither was possible, you might want to consider reinvesting your capital in a more profitable way.

ANALYZE YOUR OWN OPERATION

The considerations discussed above are not intended to be all inclusive. Other factors may also be worth analyzing to determine their influence on the accuracy of the profit figure. Using this Aid as a guide, each manager should endeavor to develop his own checklist of potential trouble spots in his particular business. This checklist should certainly be discussed with your accountant so he will understand your purpose in questioning these areas. Frequently, he will be able to offer valuable suggestions.

FOR FURTHER INFORMATION

Readers wishing to explore further the subject of statements and analyses of profitability may refer to the following publications. Consistent with the objectives of these Aids, this listing is intended only as a starting point. It should not be considered as an all-inclusive index. No slight is intended towards authors whose works are not mentioned.

(1) *Profit Management*, by F. V. Gardner et al. McGraw-Hill Book Company, Inc., 330 West 42d Street, New York 36, N. Y. 1955. $6.

(2) *Practical Distribution Cost Analysis*, by D. R. Longman and Michael Schiff. Richard D. Irwin, Inc., 1818 Ridge Road, Homewood, Ill. 1955. $7.80.

(3) *Financial Statements: Form, Analysis, and Interpretation*, by R. D. Kennedy and S. Y. McMullen. Richard D. Irwin, Inc., 1818 Ridge Road, Homewood, Ill. 1952. $7.80.

(4) *Guides for Profit Planning*, by B. La Salle Woelfel. Small Business Administration, 1960. Available from Superintendent of Documents, Washington 25, D. C. 25 cents.

(5) *Ratio Analysis for Small Business*, by Richard Sanzo. Small Business Administration. 2nd Ed. 1960. Available from Superintendent of Documents, Washington 25, D. C. 25 cents.

SMALL BUSINESS ADMINISTRATION

SMALL MARKETERS AIDS No. 68

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DEPRECIATION COSTS - DON'T OVERLOOK THEM

By *Carl P. N. Jensen*, Lecturer,
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SUMMARY

Sometimes the small marketer overlooks the impact of depreciation expenses on his firm. Yet it is impossible to figure true profit or loss without considering depreciation because it affects the worth of nearly every tangible asset.

This Aid discusses depreciation as a business expense. It explains how depreciation is determined and emphasizes the importance of periodically setting aside equipment-replacement funds. Included is a simple record form which the owner-manager can use to keep track of his depreciation expense.

The Aid points out the limitations which tax laws put on depreciation allowances and urges the owner-manager to seek professional help with depreciation problems.

With the help of a new fork-lift truck, merchandise is stacked against the wall of a small wholesale house. Reduction of labor costs and helping to give customers faster service makes this new truck sound good to the owner-manager. As he reviews the bill of lading with his foreman, he thinks, "There's one thing that's not creating problems."

On the surface he is right. But built into the new fork-lift truck and other physical equipment are future problems. True, the problems are long-range, but alert managers realize they have to start preparing for them now. Three major equipment problems are:

(1) Your new equipment is on the road to the junk heap. You may get only scrap value out of it at the end of 5, 10, or 15 years--when you have to replace it.

(2) When should your business replace this equipment?

(3) How can you set aside the money for replacing equipment before it is worn out?

THE CHIEF DANGER

For many small marketers, the chief danger about depreciation is that it is a non-cash, not-out-of-pocket cost. You don't have to hand over actual money at the end of the month.

As a result, it is easy to overlook depreciation and its continuous drain on a business. It is easy to spend money which should have been held back--earmarked for repair, renovation, remodeling, and replacement. In some cases, the owners of a firm pay themselves money which they should have kept in the business to offset the drop in values as assets wear out or get out of date.

As a firm's assets waste away from depreciation, some portion of its competitive strength is lost, too. To stay competitive you have to keep your assets in shape. The key to "keeping in shape" is an understanding of how depreciation works and a regular accounting for it.

DETERIORATION OF EQUIPMENT

When you buy a piece of equipment--a delivery truck, display case, cash register or the like--you buy an expense. This expense is the using up of that piece of equipment. The "road to the junk heap" is partly deterioration--the wear and tear on equipment through use or lack of use. The "road" also includes obsolescence--the equipment's getting out-of-date. The combination--deterioration plus obsolescence--is called "depreciation" in this Aid.

You cannot stop depreciation. But you can slow it down or speed it up. You slow it down by: (1) doing operational maintenance, (2) doing preventive maintenance, and (3) making repairs. These are expenses of your business. If you neglect your equipment, you speed up its depreciation.

On the other hand, you have no control over obsolescence. A manufacturer may bring out new dry-cleaning equipment, for instance, which makes your present equipment obsolete, or at best only marginally competitive.

- Three Elements Make Total.

If you buy a frozen food display case, for example, you actually purchase an asset which

constantly declines in value. There are three important elements to consider:

(1) The initial cost of the case itself, (2) the installation cost, and (3) the salvage value of the case--which you subtract from elements (1) and (2).

If the case costs you $1,500, and installing it costs $300, then you paid out $1,800. If you can get $200 as salvage value when the case is worn out, you subtract this $200 from the $1,800, leaving a balance of $1,600. This $1,600 is the amount of future expense you have bought.

• Subtract from Income.

Whether you use the equipment to produce sales and services, or let it stand idly by,* you face a decline in value of your asset--the equipment. This lessening in value is a periodic business expense. You should subtract it from your current income along with other expenses of your business when figuring your profit for a specific period of time.

YOUR BUSINESS OPERATIONS

You work and expect to operate at a profit. Profit is the difference between business income (sales) and business expenses (cost of sales). Income doesn't have to be in cash. It can be in accounts receivable or other amounts owed to you.

Expenses are not always in cash, either. They can be in accounts payable or the loss of an asset. You consider all income and expenses when you regularly make up your business operating statement. Depreciation is to be included.

Compute your annual depreciation expense by the simple rule: Equipment cost plus installation less salvage value, divided by the useful life of the equipment. In the display case example, the base for depreciation is $1,600. With a 10 year life the annual depreciation is $160.

• Deducting From Asset.

You deduct the depreciation of equipment from income as a business expense. You also deduct a similar amount from the asset. You may accumulate the deductions in a separate reserve-for-depreciation account.

When the reserve-for-depreciation account, plus salvage value of the equipment, equals the total cost of equipment installed, that asset is said to be "fully depreciated." From that point on no further depreciation expense is charged for it.

KEEPING SCORE

When you deduct the depreciation expense from your firm's income, you reduce your tax liabilities. When you put this depreciation expense into a reserve-for-depreciation account, you are keeping score on your "debt" to depreciation.

In the barber shop equipment example in the table on page 3, column 9 shows you are allowed $366 for depreciation of the listed equipment at the end of the year. You deduct this $366 from your income, in this case, to pay the debt credited to your reserve-for-depreciation account. Column 10 shows that, to date, you have used up the equipment to the amount of $468.

Meanwhile, you may be investing the $468 in inventory, or in some other way, to help generate more sales and profits. Some firms use part of their depreciation money in the business and invest part of it in securities or savings.

How you handle this money depends on many things. You can set it aside at a low interest rate and have that much less operating money. Or you can put it to work in your business where it will help to keep your finances healthy.

Remember, however, that you must be prepared financially when it is time to buy replacement equipment. A reserve-for-depreciation account on your books can help to keep you aware of this. It helps you keep score on how much depreciation or replacement money you are using in your business.

Another point to watch is: When do you replace a piece of equipment? A general answer is: When it is no longer competitive. This may mean that sometimes you can still use a piece of equipment for several years after you have totally depreciated it. Then it may mean that in some cases technological or marketing changes demand that you replace a piece of equipment several years before you finish depreciating it. If so, recognize that your original estimate was off and go ahead and replace the obsolete equipment with new competitive equipment as soon as you can.

Keeping score with a reserve-for-depreciation account helps you to know when you need to convert some of your assets into replacement cash. If, for example, you know on January 1 that your delivery truck will be totally depreciated by June 30, you can review the situation objectively. You can decide whether you ought to use the truck longer or replace it. If you decide to replace it, then you can plan to accumulate the cash and time the purchase in order to make the best deal.

DETERMINATION OF DEPRECIATION

Where can you learn how to figure depreciation? There are three general sources:

(1) From your own knowledge of your equipment you can determine how fast it is wearing out. You can also tell when it is becoming obsolete.

(2) The Internal Revenue Service publishes Bulletin "F" (see For Further Information on page 4.) which has a detailed list of how long

*For tax purposes depreciation starts when an asset is placed in service and ends when it is removed from service.

STRAIGHT LINE DEPRECIATION BASED UPON THE LIFE OF THE ASSET

Col. 1	Col. 2	Col. 3	Col. 4	Col. 5	Col. 6	Col. 7	Col. 8	Col. 9	Col. 10	Col. 11
Item	Cost Installed	Salvage	Balance	Life in Years	Percentage Rate	Prior Year's Depreciation at Start of Year	Balance	Current Year Depreciation	Depreciation to Date at End of Year	Asset Balance at End of Year
1. Barber chairs	$1,700	$200	$1,500	15	6-2/3	$200	$1,500	$100	$300	$1,400
2. Clippers	175	15	160	4	25	80	95			
3. Dryers	200	20	180	5	20	72	128	36	108	92
4. Waving machine	250	50	200	5	20	80	170			
Total at Start of Year	$2,325	285	2,040	-	-	432	1,893			
5. Trade in old clippers	(175)	(15)	(160)			(80)	(95)			
6. New clippers* ($125 + $95)	260	20	240	4	25			60	60	200
7. Waving machine junk	(250)	(50)	(200)			(80)	(170)	170	0	0
Year End	$2,160	$240	$1,920			$272	$1,628	$366	$468	$1,692

* Cost of clippers - $125, installation - $40, undepreciated balance - $95: Total - $260.

pieces of equipment will generally last. Most types of buildings and equipment are listed by industries. You can use this if you have no other data. But remember that Bulletin "F" data are averages, and not necessarily the rates applicable to your business.

(3) When you bought the equipment the seller may have told you how many years the equipment would last. You can use this data to measure the wear and tear on your equipment.

• A Case of Straight Line Method.

Barber shop or beauty parlor equipment can illustrate the straight line method of depreciation. This equipment depreciates at varying rates.

Column 5 in the table on page 3 shows the approximate productive life of the equipment before it must be replaced. These figures were supplied by a barber supply agency who used Bulletin "F" to determine the years of useful life. (Note: Depreciation in point of time is considered identical to the terms of leases on the premises where installed when the depreciable property becomes a part of the rented premises.)

The total of the depreciation column for the current year (column 9) is the depreciation expense for the year. This is the amount by which the value of your equipment is reduced or added to the reserve-for-depreciation account. Or it is an allowance for depreciation on your books. It will be the same each year until you make a change in equipment or conditions.

• Using A Book.

You may want to put your table in a columnar book. You can use the additional pages to continue your schedule of equipment and so on as shown in the table on page 3.

You delete traded or junked equipment as indicated by item 7 in the table. The balance of the reserve-for-depreciation account indicates the amount of your replacement resources.

EXTENDING OR SHORTENING USEFUL LIFE

With good maintenance and repair your truck, counters, display cases, or machines may last longer than you expected. With hard use they may possibly wear out sooner than you expected. Improved equipment may come out and make your equipment obsolete.

You may be able to meet these problems partially by recognizing early that by the time you have to buy replacement equipment you may need more money than is indicated by the depreciation schedules. You may also need additional cash because you don't want to buy exactly the same item again, but rather the current version. For example, if you were replacing a 1951 typewriter you would be faced with the facts (1) that typewriter prices have gone up, and (2) that you now want the latest model. Both conditions would require more dollars than were needed in 1951. Those dollars have to come from somewhere. Retained earnings is often the most attractive source.

If this typewriter cost you $365 in 1951 and you estimated that in 10 years its replacement cost will be $475, you might keep in mind this additional $110 equipment replacement element in setting your sales prices. In weighing the pros and cons of this approach, however, there are two points which deserve careful thought: (1) taxes and (2) rental possibilities.

• Added Income and Taxes.

The extra cost element added in your prices becomes income. It will be included in your profits. It is NOT an expense of operation from an Internal Revenue or Financial statement standpoint. So while you are providing for the future replacement cost you are also

building additional income and creating a larger income tax liability. And you have to be careful about pricing your goods too high.

Remember that the basis for determining depreciation expense is the actual cost of your equipment. You cannot allow for the future replacement price when figuring your taxable income.

•Renting Equipment

You may be considering renting equipment instead of buying new equipment. Renting requires less initial capital, and often less maintenance. The rental fee includes: depreciation of the equipment, interest on the investment, and a profit to the renting agent.

You will want to investigate renting before you buy equipment. Weigh advantages against cost. One advantage of renting is you can keep your equipment up to date when rapidly developing technology makes certain machines obsolete every year or so. If you rent, depreciation and replacement are the lessor's problems.

DEPRECIATION AND INCOME TAXES

Some men are attracted to the possibilities of accelerated depreciation as a way of reducing tax liabilities. Actually, when a "fast write-off" is worked out with the Internal Revenue Service, the advantage is in timing, not in amount of depreciation. Remember no matter how you divide up your depreciation allowance, you can deduct only your equipment's cost.

If you have kept adequate records, setting forth clearly the depreciation sustained, you should have no trouble with the IRS.

If you use some of the methods provided in the law such as accelerated rates or sum-of-the-digits methods, you may save taxes now. These special advantages apply to special situations. However, in later years you would probably pay tax on income without a deduction. You may not gain anything in the long run by paying less taxes now and more later.

SELLING AN ASSET

What if you decide to sell an asset you no longer need? You may get less for this asset than its remaining value. Or you may get more. What happens in either case?

If you receive LESS than the remaining value, the difference is a reduction of income in the current year. This may result in a loss for the year. Provided certain conditions are met, that loss can be deducted for tax purposes in the 3 prior years or in the 5 years following. (See Sections 1231 and 1371 of the 1954 code.) You lose little in tax on your business income.

If the amount you receive is MORE than the remaining value it is a gain. It is added to your current year income. It increases your profit and income taxes. It is a "capital gain," and is not taxed in the same manner as regular income. The tax is limited to 25 percent of the gain, if it qualifies as the sale of a capital asset, held for more than 6 months under Section 1231. This is a special concession on the sale of assets used in the business where there is a gain on the sale.

SEE YOUR ACCOUNTANT

You may gain by investigating the different methods of treating depreciation and disposition of assets. In inflation you may need a different approach than during a recession.

Your best approach is through a qualified advisor. He can help you to have the records you need to keep track of depreciation. These records will also help you to file more accurate income tax returns.

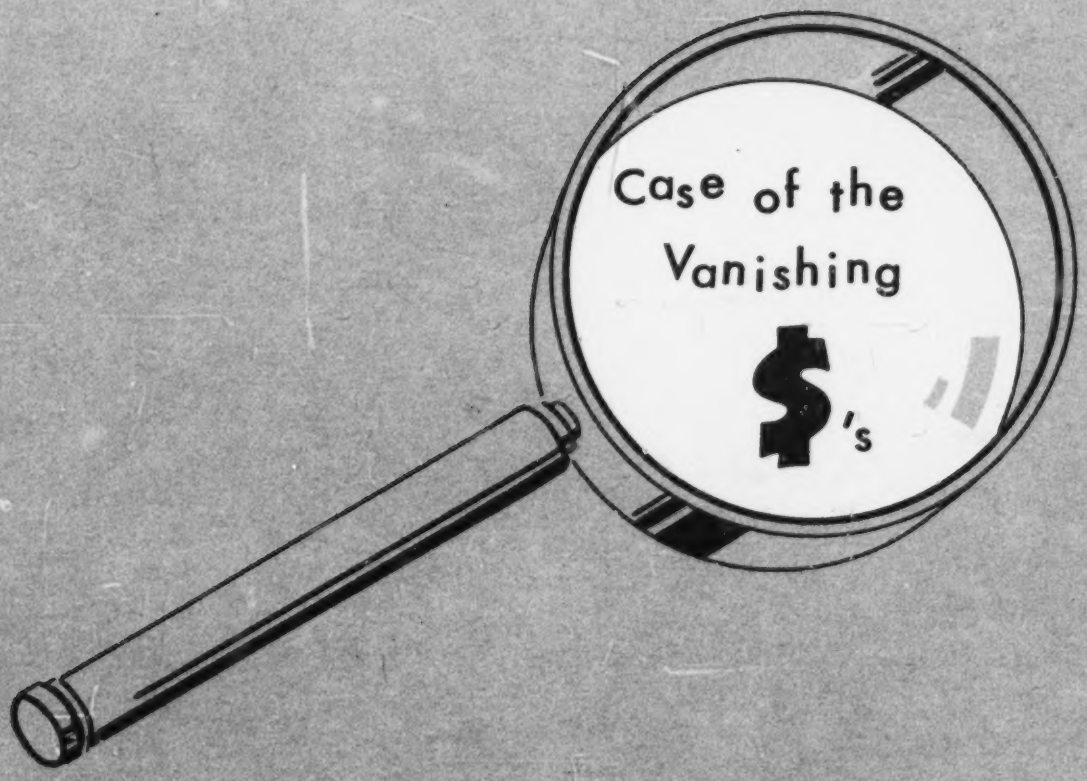
FOR FURTHER INFORMATION

Readers who wish to explore further the subject of depreciation may be interested in the references indicated below. This list is necessarily brief and selective. However, no slight is intended towards authors whose works are not mentioned.

"How Good Records Aid Income Tax Reporting" in *Management Aids for Small Business, Annual No. 3.* Small Business Administration. 1957. Available from the Superintendent of Documents, Washington 25, D. C. 45 cents.

Tax Guide for Small Business. U. S. Treasury Department Publication No. 334. Internal Revenue Service. Available from your District Director of Internal Revenue or the Superintendent of Documents, Washington 25, D. C. 40 cents.

Bulletin "F" Tables of Useful Lives of Depreciable Property. U. S. Treasury Department. Publication No. IRS 173. Internal Revenue Service. Available from the Superintendent of Documents, Washington 25, D. C. 30 cents.



CASES IN POINT

Case Studies for Depth Penetration

Section

The case method has proven stimulative and effective in many administrative management courses. The following case material is suggested as a means of encouraging discussion.

It is suggested that one full session be devoted to the presentation of the topic as outlined in this manual. A case can sometimes be used to stimulate or augment the discussion period that follows the presentation. This could be one way of expanding the basic materials into an advanced course on the subject.

THE CASE METHOD OF STUDY

What is the case method? The case method is a teaching device that helps the student learn through exercising the reasoning and decision-making processes. This can be contrasted with other popular teaching techniques which place stress on learning (or memorizing) an accumulation of past knowledge on a given subject. The case method stresses thinking rather than memorizing; it is a dynamic or active method rather than a passive one.

What is a case? A case is a description of an actual or true-to-life business situation. It is a statement of facts, opinions, and judgements -- in short, it is a problem.

The case method is particularly useful in teaching businessmen because it utilizes real, practical problems rather than abstract concepts. Properly used, it provides a realistic environment that causes the participant to become involved and holds his interest. It provides experience in performing essential parts of the administrative tasks without incurring the penalties of a wrong decision on the job. It develops within the individual the process of making decisions, and forces him to think analytically and constructively.

The student also learns the value of group discussion and analysis. Each member of the case discussion group contributes from his unique experience, and each gains from the others. The group knowledge and experience will exceed that of any individual participant -- including the instructor.

The following check-list is suggested as an outline procedure for conducting case study and analysis:

Suggestions for Case Study

1. Read the case carefully for general content.
2. Arrange the facts of the case in order of importance.
3. Recognize and define the major problem(s) that need solution.
4. Analyze the problems and their relative importance.
5. Search for and establish alternative solutions.

6. Select the most desirable of the appropriate solutions.

7. Analyze your probable solutions--set up the pros and cons of solutions, giving value to each.

8. State your choice, decision, or final conclusion--be prepared to defend it.

9. Stipulate the plan or plans for implementing the decision.

THE ELMER KUPPER CASE[1]

In 1954, Elmer Kupper opened his own retail store. At the end of 1955, his first full year of operation, he thought he had done moderately well, and he was therefore somewhat chagrined when the trade association to which he belonged sent him figures which indicated that he had operated at a loss.

Mr. Kupper had been employed as manager of the local unit of a chain store for several years. In 1954 he had received an inheritance, and this, together with his savings, provided him with enough funds to buy a small store building on the main street of his town for $30,000, in which he opened his store.

He joined the trade association to which several thousand independent retailers in the same line of business belonged. One of the services furnished by this association was the annual compilation of typical operating figures of member firms. These figures were prepared by Hartje & Mees, a large public accounting firm. Early in 1956, Hartje & Mees sent Mr. Kupper a standard form and requested that he report his revenue and expenses on this form and return it so that his figures could be averaged in with those of other member stores. Exhibit 1 shows the figures, which, with some difficulty, Mr. Kupper entered on this form.

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[1]Reproduced by permission of the President and Fellows of Harvard College. This case appears in Management Accounting by Robert N. Anthony, published by Richard D. Irwin, Inc.

Exhibit 1

ELMER KUPPER

Income Statement for 1955, as Prepared by Mr. Kupper

Gross sales		$65,927
Less: Returns and allowances to customers		2,426
Net sales		$63,501
Cost of merchandise sold		43,086
Gross margin		$20,415
Salaries and wages	$7,232	
Advertising	1,182	
Supplies and postage	793	
Taxes, insurance, repairs, and depreciation on building	1,347	
Heat, light, and power	426	
Business and social security taxes	992	
Insurance	472	
Depreciation on equipment	375	
Interest expense	240	
Miscellaneous expense	1,827	
Income taxes	1,220	
Total Expense		16,106
Net Profit		$ 4,309

Subsequently, he received a request from Hartje & Mees for information on his salary and on the rental value of his building, Mr. Kupper answered substantially as follows:

> I own my own business, so there is no point in my charging myself a salary. I drew $6,000 in profits from the business in 1955 for my personal use. My annual salary as manager of a Mogell store in recent years was $5,000, although I don't see what bearing this has on the figures for my own store.
>
> I thought I made it clear in my original submission that I own my own building. It would cost me $3,500 a year to rent a similar building, and you can see from the figures that I save a considerable amount of money by not being forced to rent.

On the basis of the information in this letter, Hartje & Mees revised Mr. Kupper's figures and sent him the income statement shown in Exhibit 2. Mr. Kupper was considerably incensed by this revised statement. He showed it to a friend and said:

> These fancy accountants have gotten my figures all mixed up. I want to know the profit I have made by operating my own business rather than by working for somebody else. They have turned my profit into a loss by calling part of it salary and part of it rent. This is merely shifting money from one pocket to another. On the other hand, they won't even let me show my income tax as an expense. I realize that the tax is levied on me as an individual rather than on the business as such, but my only source of income is my store, and I therefore think the tax is a legitimate expense of my store.

Exhibit 2

ELMER KUPPER

Income Statement for 1955, as Revised by Hartje & Mees

Gross sales		$65,927
Less: Returns and allowances to customers		2,426
Net sales		$63,501
Cost of merchandise sold		43,086
Gross margin		$20,415
Salaries and wages	$12,232	
Advertising	1,182	
Supplies and postage	793	
Rent	3,500	
Heat, light, and power	426	
Business and social security taxes	992	
Insurance	472	
Depreciation on equipment	375	
Interest expense	240	
Miscellaneous expense	1,827	
Total Expense		22,039
Net Loss		$ 1,624

Questions

1. How much profit did Mr. Kupper's store earn in 1955? How do you explain the difference between the profit shown on Exhibit 1 and the loss shown on Exhibit 2? What, if any, accounting principles are violated on either statement?

2. Should Mr. Kupper continue to operate his own store? Has he been successful?

3. Does the income statement that would be most useful to Mr. Kupper differ from the income statement that would be most useful in compiling average figures for use by the trade association membership?

INSTRUCTOR'S NOTES ON CASE

This case highlights some of the questions that small-business men often have regarding financial statements. Class discussion should bring out the reasons for complete separation of the business finances from the personal finances of the owner.

1. Calculations of profit will vary depending on the assumptions made. The two income statements shown in the case represent extreme positions. Most profit estimates will fall between these two examples. Since the main purpose of the income statement is to reflect the true financial position of the company, Mr. Kupper is certainly wrong in including his personal taxes as an expense of the business and excluding his salary or draw from expenses. (He should at least include as much in wages as he might earn elsewhere for the same work--$5,000 in this case.) On the other hand, there can be some justified objections raised concerning the imputing of rent expense by Hartje & Mees. There is nothing wrong with Kupper's owning his own building, if the proper asset and expense entries are made for this on both the balance sheet and the income statement. Mr. Kupper should include the building in fixed assets on the balance sheet, and depreciation should be taken into account for the building on both the income statement and the balance sheet. Other expenses associated with the building such as repairs, taxes, and insurance would also be business expenses.

2. If Mr. Kupper's salary of $5,000 is added to expenses and his personal income taxes are excluded, his profit would be $529. If his equity in the business is the $30,000 he initially put into it, his return on investment is 1.75 percent. Mr. Kupper has not been a smashing success. He could have retained his job as chain store manager and put the $30,000 into savings banks or U. S. savings bonds and received more than twice his current return on investment. On the other hand, he is making a profit, and perhaps the knowledge of the true position of his business through good bookkeeping information will help him control the business and make a better profit.

3. The purpose of the accounting firm's statement is to give a representative composite report for the typical firm in this retail field. That is why they imputed rent rather than accounting for the ownership of the building. Mr. Kupper's purpose in keeping financial records should be to show him the true profit picture of his business. Bookkeeping records can be drawn up in several ways, depending on what the purpose of the statement is.

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THE JAMES STANTON CASE[1]

James Stanton took his wartime savings, some money his mother had left him, some material he found in his father's garage, and started business for himself. It wasn't a large business, but it did give him the pleasure of being his own boss and combined the inside work of manufacturing with the outside work of selling. His product was a painted wooden toy tank that was priced at retail at $14.50 each. It was a realistic toy, well designed, and intended for boys aged six to ten years. Mr. Stanton was an energetic person, and he soon had output rolling. This had been accomplished despite difficulties, chiefly with paint, but at last Mr. Stanton had found a supplier who promised to provide him with paint of the desired quality.

At the end of the first six months' experience, James Stanton took pride in his first profit and loss statement. He hoped it would be the forerunner of a long series of reports showing operations "in the black." This statement was as shown in Exhibit 1.

Exhibit 1

JAMES STANTON

Income Statement for Six Months Ending December 31, 1946

Net sales			$8,300.35
Beginning inventory, July 1, 1946		$ 150.00	
Purchases of material	$5,005.00		
Labor	8,105.45		
Rent of machines and space	2,090.10	15,200.55	
		$15,350.55	
Less: Inventory, December 31, 1946		11,490.50	
Cost of goods sold			3,860.05
Gross profit			$4,440.30
Advertising and other selling expenses		$ 1,510.23	
Interest		52.50	1,562.73
Net Profit			$2,877.57

[1]Reproduced by permission of the President and Fellows of Harvard College. This case appears in Management Accounting by Robert N. Anthony, published by Richard D. Irwin, Inc. The case was written by Charles A. Bliss.

Mr. Stanton's "balance sheet" as of December 31, 1946, appears as follows:

Assets:		
Cash	$ 305.90	
Inventory, at cost	11,490.50	$11,796.40
Less: Liabilities:		
Note payable, L. K. Stanton	$ 3,000.00	
Accounts payable	2,739.50	5,739.50
Leaving James Stanton's net worth as		$6,056.90

Question

1. As best you can measure them, what were James Stanton's accomplishments and what were his prospects?

INSTRUCTOR'S NOTES ON CASE

At first glance, many in the class may conclude that Mr. Stanton is in pretty good shape and on the road to a fairly successful business. However, there is one major weakness in Mr. Stanton's present position. If the class fails to see anything wrong with Mr. Stanton's operations, the instructor might ask them to comment on the company's inventory position.

Mr. Stanton has just passed the major selling period for his product--the Christmas season. He is left with a large inventory which would be hard to liquidate in a short time, and which is not likely to turn over very rapidly until the next Christmas season. He has accounts payable of $2,739.50 and only $305.90 cash with which to pay them. Although his business has a net worth of $6,056.90, he has too much inventory for a seasonal product. In addition, he has relatively high short-term obligations in terms of the amount of cash on hand.

Mr. Stanton's profit is only a paper profit, and he could be forced into bankruptcy at any time by his creditors.

THE INCUBATOR

A How To Do It Section

Experience has shown that people achieve maximum benefit from a conference, staff meeting, or training session when a period of incubation follows the implantation of the new idea, new information, or "new slant."

This is a do-it-yourself section that will allow the participants to try out or apply the ideas and information gained from this session.

This material may be reproduced locally for distribution to course participants.

SUGGESTED INCUBATOR ASSIGNMENTS

1. Draw up or obtain copies of your latest accounting statements.

    a) Balance Sheet

    b) Income Statement

    c) Funds Flow Statement

2. If you had an additional $2,000 available to invest in your company, specifically how would you use these funds to gain the most long-run return for your company?

3. If you wished to expand your company, would you do it through long-term borrowing or through increasing equity capital? Why?

4. What do you consider your most important balance sheet asset? What is the purpose of the subsidiary bookkeeping records mentioned in this discussion? How is that purpose effected?

5. Give the reasons for keeping property records and an insurance register. Why is depreciation of fixed assets often overlooked by small-business managers?

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